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BALANCING POLICY SPACE AND POLICY CONSTRAINTS?

A CRITICAL LEGAL ANALYSIS OF WTO DISCIPLINES ON SUBSIDIES AND COUNTERVAILING MEASURES

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De 'promovendus' is 'hij die vooruit beweegt'. Een beweging, een boeiende beklimming waarvan noch de richting, noch het eindpunt zijn uitgestippeld. Mijn diepe dank gaat uit naar al degenen die me uitgedaagd en ondersteund hebben om zulke beweging te pogen maken.

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Dominic Coppens,
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Australia – Ammonium Sulphate	Working Party Report, *The Australian Subsidy on Ammonium Sulphate,* GATT/CP.4/39, adopted 3 April 1950, BISD II/188
EEC – Oilseeds I	GATT Panel Report, *European Economic Community – Payments and Subsidies Paid to Processors and Producers of Oilseeds and Related Animal-Feed Proteins*, L/6627, adopted 25 January 1990, BISD 37S/86
Italy – Agricultural Machinery	GATT Panel Report, *Italian Discrimination Against Imported Agricultural Machinery*, L/833, adopted 23 October 1958, BISD 7S/60
Spain – Soyabean Oil	GATT Panel Report, *Spain – Measures Concerning Domestic Sale of Soyabean Oil – Recourse to Article XXIII:2 by the United States*, L/5142, 17 June 1981, unadopted
US – Malt Beverages	GATT Panel Report, *United States – Measures Affecting Alcoholic and Malt Beverages*, DS23/R, adopted 19 June 1992, BISD 39S/206
US – Tobacco	GATT Panel Report, *United States Measures Affecting the Importation, Internal Sale and Use of Tobacco*, DS44/R, adopted 4 October 1994, BISD 41S/131

GENERAL INTRODUCTION

The basic set of existing multilateral disciplines on governments' use of subsidies and countervailing measures has been in place since the birth of the World Trade Organization (WTO) in 1995. The Uruguay Round negotiations (1986-1994) resulted in the Agreement on Subsidies and Countervailing Measures (SCM Agreement), disciplining subsidization affecting trade in goods, as well as in the Agreement on Agriculture, elaborating specific disciplines on agricultural subsidies.

This strengthening of subsidy disciplines elicited a vivid discussion on whether the SCM Agreement overly confines developing countries' policy space to use subsidies as a development tool. For instance, the UNCTAD has openly regretted these countries' loss of policy space resulting from the Uruguay Round trade agreements. The 2006 UNCTAD Trade and Development Report referred to the SCM Agreement as one of the agreements that 'impinges directly on national rulemaking authority'.[1] The WTO Director-General, Pascal Lamy, firmly responded to what he called an accusation:

> The alternative, it seems, would be to have no subsidy disciplines, which raises *an intriguing question*. Do we want to argue that the best contribution the WTO can make to development is to ensure that developing countries have no obligations in this area? Or that export subsidies should be allowed?[2]

However, this 'intriguing question' is not confined to the situation of developing countries. Indeed, it is equally disputed whether the current WTO subsidy disciplines leave sufficient policy space upon developed countries. Some scholars have reached the conclusion that the SCM Agreement is one of the 'least economics-informed agreements in the WTO'.[3] Others have even revealed a 'basic dilemma' in the restrictions on export subsidies, as they precisely run 'counter to the essential purpose of international trade agreements' to expand trade beyond unilateral levels.[4] This debate on the balance struck under the WTO subsidy regime has further intensified since the outbreak of the global financial and economic crisis in 2007/2008. While some have questioned whether the SCM Agreement leaves sufficient policy space to adequately respond to the challenges of the crisis, others have precisely

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[1] UNCTAD, *Trade and Development Report, 2006 – Global Partnership and National Policies for Development* (New York: United Nations Publications, 2006), 237 pp., at 169.

[2] WTO, *Lamy Calls for Debate on 'Flexibility' and What Makes Good 'Policy Space'* (27 September 2006) (emphasis added). Available at: http://www.wto.org/english/news_e/sppl_e/sppl40_e.htm.

[3] P. C. Mavroidis, P. A. Messerlin, and J. M. Wauters, *The Law and Economics of Contingent Protection in the WTO* (Cheltenham: Edward Elgar, 2008), 606 pp., at 462.

[4] M. E. Janow and R. W. Staiger, 'Canada – Dairy, Canada – Measures Affecting the Importation of Dairy Products and the Exportation of Milk (WT/DS113; WT/DS103; DSR 1999:V, 2057, DSR 1999:VI, 2097; DSR 2001:XIII, 6829; DSR 2001:XIII, 6865; DSR 2003:I, 213; DSR 2003:I, 255)', in H. Horn and P. C. Mavroidis (eds), *The American Law Institute Reporters' Studies on WTO Case Law – Legal and Economic Analysis* (Cambridge: Cambridge University Press, 2007), 249-292, at 264.

pointed to the current system's weaknesses to prevent detrimental subsidy competition among WTO Members. A parallel discussion applies to the flexibility on agricultural subsidies left under the Agreement on Agriculture. Here, it is rather debated whether the current balance does not incline toward too much policy flexibility.

This dissertation precisely aims at addressing this 'intriguing question' from the perspective of both developing and developed countries. Does the set of multilateral disciplines, elaborated in the SCM Agreement and the Agreement on Agriculture, find an adequate balance between 'policy space' left to WTO Members and 'policy constraints' imposed upon them? To answer this overarching research question, a threefold analysis should be conducted. First of all, an *economic analysis* should help understand why governments have an incentive to offer different forms of subsidies and to impose countervailing measures and what the welfare impact of such interventions is. Next, a *legal analysis* should address the existing constraints on both types of interventions under the WTO. Confronting the economic and legal analysis, a *normative analysis* should finally evaluate whether an appropriate balance is reached under existing multilateral disciplines.

This study embraces this threefold analysis not only in a general way but also with regard to the disciplines on export credit support in particular. To this end, four general parts are distinguished.

Part I entails the economic analysis and critically reviews economic theory and empirical evidence on governments' rationales to subsidize and install countervailing measures. In fact, this analysis aims at responding both a positive as well as a normative question. Why *do* governments in reality offer subsidies and impose countervailing duties? At the same time, why *should* governments have an interest to preserve policy space to make both types of interventions? The basic assumption in the latter normative analysis is that governments should strive at maximizing welfare or at fostering sustainable development more generally. This Part starts from explaining how a welfare-maximizing country would not be interested in offering subsidies and imposing countervailing duties in the absence of market failures. Yet, a government's stance on both types of interventions might change in the presence of market failures inhibiting welfare and economic growth. Therefore, the analysis shifts to strategic trade theory as well as to specific market failures that might be corrected as part of an industrial policy in both developed and developing countries. Finally, this first Part ends with a discussion of a number of non-economic rationales, such as environmental protection or political-economy reasons, that might likewise explain why governments offer subsidies and impose countervailing measures.

Part II conducts the core legal analysis and turns to the framework elaborated under the SCM Agreement and the Agreement on Agriculture. Tracing the origins of existing disciplines, this legal analysis will first provide some insights on why countries have agreed to confine their policy space on subsidization and the imposition of countervailing measures. Next, the current disciplines imposed upon both developed and developing countries are systematically discussed. Finally, it is examined to what extent the Agreement on Agriculture still delineates more flexibility on agricultural subsidies. In this legal analysis, the vast amount of case law is integrated and critically evaluated.[5] Likewise, proposals touching upon these disciplines that are tabled in the Doha Round negotiations are assessed.

Part III illustrates the threefold analysis in a case study on export credit support. Here, the analysis focuses on the policy space left to WTO Members to offer export credit support for industrial and agricultural products as well as for services. The complexity and particularity of the legal framework as well as the specificity of the rationales for government intervention explain why a separate case study is devoted to this topic. Grasping and evaluating the balance struck under the WTO regime on export credit support seems far from evident. Observe, for instance, that the WTO Director-General has urged for increased export credit support to fill the gap in private trade financing resulting from the financial and economic crisis. However, by analyzing existing disciplines in light of the case law, it will be demonstrated that WTO Members simply seem to be prohibited to respond to this call. Disciplines on export credit support for industrial and agricultural products will be explored in parallel so as to elucidate the differences between both regulatory regimes. Next, this Part will turn to export credit support affecting trade in services. This is only meant to illustrate the limited reach of substantive disciplines on subsidies under the General Agreement on Trade in Services (GATS). After discussing the proposals circulating in the Doha Round negotiations, a normative assessment of the disciplines on export credit support for industrial and agricultural products will be conducted.

Part IV finally arrives at the overarching normative analysis on the appropriateness of the balance between 'policy space' and 'policy constraints' under WTO disciplines on subsidies and countervailing measures, based on the premise that trade agreements should foster global welfare. The policy space under the SCM Agreement and Agreement on Agriculture, elaborated upon in Part II and further explained in Part III, is assessed in light of the rationales for government interventions on subsidies and countervailing measures as revealed in Part I. After evaluating the scope of the SCM Agreement, the policy space left to WTO Members on domestic as well as on export subsidies will be assessed. This exercise is conducted for

[5] This manuscript was finalized in June 2010 prior to the issuing of the Panel Report in *European Communities and Certain Member States – Measures Affecting Trade in Large Civil Aircraft* (WT/DS316/R, issued on 30 June 2010).

developed and developing countries, respectively. Next, WTO Members' flexibility to use unilateral countervailing action is critically evaluated. Finally, the analysis reflects upon the query whether the existing disciplines should be reconsidered in light of government interventions in response to the financial and economic crisis.

PART I

RATIONALES FOR OFFERING SUBSIDIES AND IMPOSING COUNTERVAILING MEASURES

INTRODUCTION AND TERMINOLOGICAL DELINEATION

This opening part analyzes governments' incentives to offer subsidies and hereto presents a literature review of economic theory and empirical studies. This question on governments' rationales to subsidize is approached from both a positive and normative perspective. First, why *does* a government *de facto* offer subsidies? Second, why *should* a government offer subsidies?[6] Complementary to these positive and normative analyses, this chapter equally addresses why other governments, when confronted with subsidized imports, (should) impose countervailing duties. The basic assumption in this normative analysis is that governments should strive at maximizing welfare or at fostering sustainable development more generally.

Some important terminological specifications apply to this opening economic literature review. A countervailing duty (CVD) refers to a special tax levied for the purpose of offsetting a subsidy bestowed on imports.[7] In general terms, the concept of 'subsidy' in the SCM Agreement 'captures situations in which something of economic value is transferred by a government to the advantage of a recipient'.[8] In this first part, the thorny issue on which situations are exactly covered by the term 'subsidy' is left aside. Parallel to most non-legal studies discussed below, this opening Part adheres to a narrow use of the term, namely as an acronym to a tax, and thus connotes to a transfer of money from the government to a private actor.[9] Taxation and subsidization are hereby considered as two alternative fiscal instruments by which a government could intervene in the market and are on this basis distinguished from non-fiscal or 'regulatory' government interventions (e.g., technical regulations). Puzzling observations that a tax or regulatory burden on some private actors might very well be considered as a subsidy onto other private actors or that a subsidy might simply compensate for another tax or regulatory burden are thus provisionally neglected. Subsequent Parts will devote sufficient discussion on whether these and other government interventions could be labeled as 'subsidies' under the SCM Agreement and/or Agreement on Agriculture. Depending on the direct recipient, 'consumer subsidies' are primarily distinguished from 'producer subsidies' in the literature. Depending on the conditions for receiving producer subsidies, different types are further distinguished. First of all, a fundamental distinction is drawn between 'export subsidies' and all other types of subsidies, often labeled 'domestic subsidies'. When discussed in the economic literature, an export subsidy is only paid on

[6] Such a distinction between a 'positive' and 'normative' theory of trade policy is made, for example, by A. K. Dixit, 'Trade Policy: An Agenda for Research', in P. Krugman (ed), *Strategic Trade Policy and the New International Economics* (Cambridge: The MIT Press, 1986), 283-304, at 296; A. O. Sykes, 'The economics of "injury" in antidumping and countervailing duty case', 16:5 *International Review of Law and Economics* (1996), 5-26, at 26.
[7] See also footnote 36 of the SCM Agreement.
[8] Appellate Body Report, *US – Softwood Lumber IV*, para 51.
[9] WTO Secretariat, *World Trade Report 2006 – Exploring the links between subsidies, trade and the WTO* (Geneva: WTO Publications, 2006), 223 pp., at 47.

production that is exported and, as it thus directly stimulates exportation, is often categorized as a ‘trade instrument’. In contrast, ‘a production or output subsidy’ is a form of domestic subsidy that is granted on all production/output, regardless whether it is exported or not. Other types of domestic subsidies are those offered to specific inputs or activities in the production process, such as subsidies for research and development (R&D subsidies) or labor subsidies. ‘Import substitution subsidies’, also named ‘local content subsidies’, are a specific sort of input subsidies as they are offered on the condition of the use of domestic over imported inputs. Whereas such production or input subsidies are mostly recurring, governments sometimes also offer non-recurring, one-time subsidies, for instance for the acquisition of fixed assets (e.g., equipment, plant). In short, producer subsidies are distinguished on the basis of the conditions attached thereto and thus on the specific activity (e.g., exports, production, R&D, acquisition of fixed asset) they directly or indirectly aim at stimulating. Accordingly, the concept of ‘subsidies’ is occasionally discerned from so-called ‘transfers’, as the latter are not conditioned on any specific use and are therefore considered to leave the allocation of resources unaffected.

With these broad, non-legal descriptions in mind, we now turn to the insights offered by economic theory explaining why individual governments who aim at maximizing welfare or economic growth would and should (not) be interested in offering one or more of these types of subsidies or in imposing CVDs. Whereas Chapter 1 addresses these rationales for subsidizing or imposing CVDs under the assumption of a perfectly functioning market, Chapter 2 analyzes this same question in situations where market failures are present. Finally, Chapter 3 takes non-economic rationales for subsidization and the imposition of CVDs on board.

1. ECONOMIC RATIONALES FOR SUBSIDIES AND COUNTERVAILING DUTIES IN THE ABSENCE OF MARKET FAILURES

Under the assumption of the absence of market failures, markets are complete and perfectly competitive and mere interaction between supply and demand results in an efficient allocation of resources and a level of output produced at the lowest possible price, which equals the marginal cost of production and the socially optimal price.[10] Put otherwise, welfare is maximized under market forces (Pareto optimum[11]) and government intervention would only *distort* efficient resource allocation by creating a wedge between the marginal cost-price and the socially optimal price. Welfare is commonly defined as the sum of consumer surplus (i.e., the difference between the price consumers have to pay and are willing to pay or their 'marginal benefit'), producer surplus (i.e., the difference between the price at which producers sell and are willing to sell or their 'marginal cost') and government revenue.

Figure 1 illustrates how, in case a country is closed to international trade (autarky), a production subsidy results in higher output (Q'_H; Figure 1) and a lower market price (P'_H; Figure 1), which obviously benefits consumers.[12] It also improves producer welfare because producers benefit from higher output as well from the subsidy which they receive on top of the new market price.[13] A production subsidy thus creates a wedge between the market price (P'_H; Figure 1) and the actual price paid to producers ($P'_H + S$; Figure 1). Yet, the net welfare effect of the subsidy is negative because the cost to the government (i.e., taxpayers) outweighs the welfare benefits to consumers and producers.[14] The net welfare loss occurs because the low market price gives consumers an incentive to consume too much (consumption distortion loss), whereas the high price paid to producers induces them to produce too much (production distortion loss). This efficiency loss of the subsidy is represented by the well-known deadweight loss triangles[15], indicating that the new equilibrium is not Pareto optimal.[16] Accordingly, in the absence of market failures, a

[10] In a perfectly competitive market, firms are price takers and can enter/exit freely and products are homogeneous. As a result, price will equal marginal costs of production. Complete markets are characterized by full information and the absence of externalities, resulting in a price which also equals the socially optimal price.

[11] Marginal costs to producers equal marginal benefits to consumers, implying that no one can be made better off without someone else being made worse off.

[12] The gain in consumer welfare is represented by the area (+d, +e, +f) in Figure 1.

[13] The gain in producer welfare is represented by the area (+a, +b) in Figure 1.

[14] The cost to the government is represented by the area (-a, -b, -c, -d, -e, -f, -g). The total welfare effect of the production subsidy is represented by the area (-c, -g) in Figure 1.

[15] The consumption distortion is represented by the area (g) and the production distortion is represented by the area (c) in Figure 1.

[16] All consumers having a marginal benefit at or above the subsidized price buy the good, which includes consumers whose marginal benefit was below the free market price (deadweight loss). Conversely, producers whose marginal cost is higher than the free market price also start producing the good in question if their marginal cost is not above the market price plus the subsidy (deadweight loss).

production subsidy is welfare reducing for the subsidizing country in a closed economy because it results in an inefficient allocation of resources.

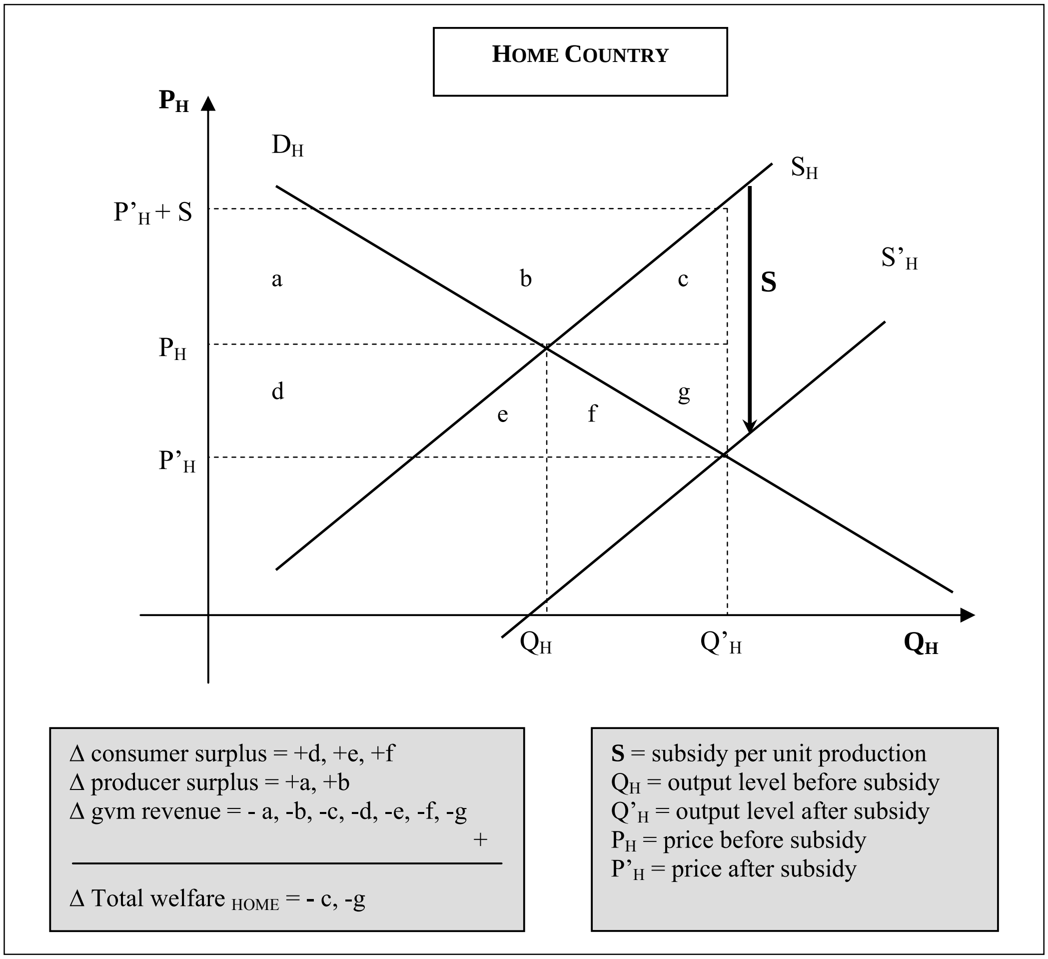


FIGURE 1: WELFARE EFFECTS OF PRODUCTION SUBSIDY BY CLOSED COUNTRY

What is the welfare effect if the subsidizing country is not closed but instead, open to international trade? In this case, a fundamental distinction has to be made between small and large countries. If a country is small, changes in its supply and demand cannot affect the world price (price taker) and thus its terms of trade (i.e., ratio of export prices to import prices), whereas such changes in a large country have an impact on the world price and its terms of trade. Subsidies by a large country to its export-competing industry affect world supply, and subsidies to their import-competing industry affect world demand. As indicated above, another important distinction is drawn between export subsidies, which are contingent upon exportation, and production or output subsidies, which are dependent upon output.[17]

[17] The analysis for other types of recurring domestic subsidies (e.g., input subsidies) is similar to the analysis on production subsidies. The analysis of non-recurring subsidies entails the extra complexity

Notice that, based on the theory of relative comparative advantage, welfare is improved if a country shifts from autarky to free trade because resources are re-allocated in a more efficient way.[18] Compared this welfare level in the absence of any government intervention, how does a subsidy impact welfare not only in the subsidizing country but also in third countries and the world as a whole?[19]

1.1. WELFARE EFFECTS OF SUBSIDIZATION BY A SMALL COUNTRY

Consider a production subsidy given by a small country. This subsidy increases domestic production and thus producer welfare, but leaves the world price unaffected and does not affect consumer welfare accordingly. A welfare loss arises to the subsidizing country because the increase in producer welfare does not cover the cost to the government (production distortion loss).[20] If this small subsidizing country is an importing country, domestic consumers will (partly) shift from more efficient foreign suppliers to subsidized domestic suppliers. Accordingly, a production subsidy has a similar effect than a tariff in protecting the domestic industry but, in contrast to a tariff, has no cost to domestic consumers. The assumption of 'small' country implies that this domestic subsidy generates no impact on third countries' welfare. Although foreign producers would export less to the small subsidizing country, this effect would be considered negligible.[21] Parallel to a production subsidy, an export subsidy also benefits domestic producers but the incentive upon them to export (lower marginal costs of exporting) contracts their supply for the domestic market at the expense of domestic consumers (higher price, lower consumption). Of course, this extra consumption distortion loss in case of an export subsidy only takes place if importation at the world price is blocked (prohibition on re-importation and restrictions on other imports).[22] Again, the small country assumption by definition implies that third countries' welfare is unaffected.[23] In sum, production subsidies offered by small countries only distort the production side of the

of determining whether it affects producers' marginal costs and thus their output decision. If not, the subsidy simply shifts welfare from the government to producers.

[18] The static benefits from trade result from specialization (shift to efficient resource allocation).

[19] World welfare is the sum of the welfare effects on the subsidizing country and the rest of the world (third countries).

[20] The marginal cost of production is higher than the price of imports for the extra output levels generated by the subsidy (represented by the deadweight loss triangle).

[21] The assumption of small country precisely means that the world price – and thus world supply – is left unaffected.

[22] If importation is not restricted, domestic consumers would shift from domestic producers, which are only willing to sell at the world price *plus* the subsidy, to importation at the (fixed) world price.

[23] Reconciling an *export* subsidy with the assumption that world supply is left unaffected might be difficult to imagine. It assumes that exporters are too small to have a noticeable effect on world supply. Alternatively, Sykes gives the example of a subsidy to exporters which have, in the short run, no capacity to expand production. Hence, they will simply continue to sell at the world market price and collect the subsidy. A. O. Sykes, 'Countervailing Duty Law: An Economic Perspective', in R. Howse (ed), *The World Trading System: Critical Perspectives on the World Economy – Volume 3 – Administered Protection* (London: Routledge, 1997), 315-380, at 329.

domestic market, whereas export subsidies and tariffs not only affect the production but also the consumption side.[24] A tariff is indeed equivalent to a production subsidy *combined with* a consumption tax.[25]

1.2. WELFARE EFFECTS OF SUBSIDIZATION BY A LARGE COUNTRY

In contrast to a small country, a production or export subsidy offered by a large country affects the world price and, therefore, also the welfare of third countries. Here, two situations should be distinguished. First, production or export subsidies to export-competing industries increase the world supply and thus put downward pressure on the world price, which has a *negative* terms of trade effect (making exports cheaper) upon the subsidizing country. Second, a production subsidy to import-competing industries in a large country could also put downward pressure on the world price, as such a subsidy reduces world demand for the good in question. Yet, this reflects a *positive* terms of trade effect from the perspective of the subsidizing country as it makes imports cheaper.[26]

We consider the welfare effects of export and production subsidies to both export- and import-competing industries. First, what are the welfare effects of export and production subsidies to export-competing industries? The welfare effect of an *export subsidy* offered by a large country is illustrated in Figure 2.[27] From the perspective of the subsidizing country, the lower price resulting from export subsidies to export-competing industries (P'_W ; Figure 2) thus negatively affects its terms of trade, creating an extra welfare loss in addition to the production and consumption distortion losses that are also present in the small country scenario.[28] Compared to this small country scenario, welfare in the subsidizing country deteriorates even more when an export subsidy is given by a large country.[29] A wedge is

[24] M. Michaely, 'A Note on Tariffs and Subsidies', 57:4 *The American Economic Review* (September, 1967), 888-891; Y-H. Yeh, 'On subsidies vs. tariffs', 38:1 *Southern Economic Journal* (July, 1971), 89-92; W. M. Corden, *Trade Policy and Economic Welfare* (Oxford: Clarendon Press, 1974), 423 pp., at 9-14; K. Anderson, W. Martin and E. Valenzuela, 'The relative importance of global agricultural subsidies and market access', 5:3 *World Trade Review* (2006), 357-376, at 359. Yet, the paper by Anderson et al does not mention (and their model does not reflect) that production subsidies given by large countries could also affect the consumption side in the subsidizing country through the terms of trade (see below, n 30).

[25] K. Bagwell, 'Remedies in the WTO: An Economic Perspective', *Working Paper* (9 January 2007), 34 pp., at 25.

[26] It is assumed that the production subsidy to the import competing industry is not that large to turn the import competing industry into an exporter.

[27] Figures 2-4 depict the welfare effects of different types of subsidies by a large country open to international trade. Next to the effect on the subsidizing country itself, the effects on world trade and the rest of the world are illustrated. Alternatively, the situation of the 'rest of the world' could be understood as an individual importing country. In these Figures, countries are considered to be either exporters or importers of the subsidized product in question.

[28] Part of the subsidy per exported product (P_W - P'_W; Figure 2) flows abroad to foreign consumers who benefit from a lower world price (P'_W ; Figure 2).

[29] However, Feenstra has developed a model (three goods and two countries) in which welfare of the subsidizing country increases as a result of an export subsidy. The necessary condition is that the

driven between the depressed world market price (P'_W; Figure 2), benefiting foreign consumers, and a higher domestic price (P'_H; Figure 2), hurting domestic consumers.

On the other hand, if a *production subsidy* is offered as in Figure 3, domestic consumers could also benefit from the lower world market price (P'_W; Figure 3) but the welfare gains to producers and consumers do not offset the cost to the government.[30] Again, the welfare effect upon the subsidizing country is therefore negative. Instead of subsidizing exporting industries by offering export or production subsidies, a welfare maximizing large country is advised to *tax* exports up to the level whereby the difference between the positive terms of trade effect and the negative distortion losses is maximized.[31]

Consumers in the rest of the world benefit from the lower world price and extra output induced by export or production subsidies, whereas foreign producers are negatively affected.[32] Taking a country perspective, net-importing countries benefit from the subsidized imports (positive terms of trade effect), whereas net-exporting countries are adversely impacted (negative terms of trade effect). A subsidy to the exporting industry thus only forms 'unfair' competition from the viewpoint of foreign import-competing and export-competing producers as they are partly replaced by subsidized exports (volume effect) and have to accept a lower price (price effect).[33] For the same level of subsidy per respectively exported product

subsidized export forms a stronger substitute to another export good or stronger complements an import good in the subsidizing country than abroad. In this case, the distortion is the large country's failure to exploit market power in the second or third good. Indeed, the first-best solution would be an optimal export tax or optimal tariff on those goods respectively. R. C. Feenstra, 'Trade Policy with Several Goods and 'Market Linkages'', 20:3/4 *Journal of International Economics* (May, 1986), at 249-267.

[30] The total welfare effect is represented by area (-c, -f, -h, -i) in Figure 3. A production subsidy given to an exporting industry (or importing industry) in a large country also indirectly creates a consumption distortion in the exporting country through its effect on the terms of trade (consumers consume too much).

[31] This export tax argument mirrors the optimal tariff theory on the import side. Large countries could be seen as having some degree of market power: they can use trade instruments to affect the world price with the aim of making imports cheaper in terms of exports. Such a terms of trade benefit could be obtained in a double way, namely by targeting either demand or supply at respectively the import or export side. On the import side, they can through the imposition of an 'optimal tariff' depress the world market price for imports. On the export side, they can through the imposition of an 'optimal' export tax cheer up the world market price. By manipulating their terms of trade, part of the revenue of the tax is derived from respectively foreign producers (on the products subject to a tariff still exported to the large country) and foreign consumers (on the products subject to the export tax still imported from the large country). Under the optimal level, this revenue outweighs the deadweight losses (efficiency loss) resulting from the tax. Failure by a large country to exploit this market power by an optimal tariff or export tax creates a so-called international or foreign distortion. A production subsidy to an importing competing industry would be a second-best option if a tariff is unavailable. For a seminal explanation on the terms of trade, see J. E. Meade, *The Theory of International Economic Policy – Volume II - Trade and Welfare* (London: Oxford University Press, 1955, reprinted 1966), 618 pp., at 272-289.

[32] The positive effect of export and production subsidies on foreign consumer welfare is represented in area (+a*, +b*, +c*, +d*, +e*) in Figure 2 and area (+a*, +b*, +c*, +d*, +e*) in Figure 3, respectively. The negative effect on foreign producer welfare is represented in area (-a*, -b*) in Figure 2 and area (-a*, -b*) in Figure 3, respectively.

[33] Applied by the Arbitrator in *US – Upland Cotton (Article 22.6 – US)* with respect to the US export credit programme 'GSM 102', which operated at subsidized terms: '(…) like any export subsidy, it can

and produced product, the effect on the terms of trade and thus the effects on third countries are larger in case of export subsidies than in case of production subsidies.[34] Therefore, export subsidies are indeed more trade-distortive than production subsidies. Importantly, the benefits to foreign consumers (increased consumption at a lower price) of such export or production subsidies outweigh the costs on foreign producers.[35] Hence, whereas welfare in the subsidizing country certainly shrinks as a result of efficiency and terms of trade losses, the rest of the world undeniably benefits overall. A subsidy by a large country to its exporting industry thus channels welfare from the subsidizing country to (consumers in) the rest of the world. But the loss to the subsidizing country is certainly not fully absorbed by a terms of trade gain in importing countries as the subsidy also creates production and consumption distortions in the latter countries.[36] From the perspective of world welfare, the export subsidy creates an inefficient allocation of resources: too much (little) production and too little (much) consumption in the exporting (importing) country. Likewise, a production subsidy to an export industry creates too much (little) production in the exporting (importing) country and too much consumption in both countries. In conclusion, compared to the situation under free trade, an export or production subsidy by a large country to its export-competing industry has a positive welfare effect on the rest of the world and on net-importing countries but a negative welfare effect on the subsidizing country itself, on net-exporting countries, as well as on global world welfare.

Yet, as pointed out above and illustrated in Figure 4, a production subsidy offered by a large country to *import-competing industries* has a similar effect on the terms of trade (through its effect on world demand) but this represents a *positive* terms of trade effect upon the subsidizing country as it makes its imports cheaper ($P'_W < P_W$; Figure 4). Therefore, an optimal production subsidy could in theory be imposed whereby the benefits to domestic producers and consumers outweigh the cost to the government.[37] Nevertheless, it has been demonstrated that a tariff would be preferable to a subsidy when a large country in a perfectly

be expected to affect both the volume of trade and the price at which trade takes place. The GSM 102 programme can potentially stimulate additional US exports and influence the price of those exports in the target markets. This illegally subsidized competition has adverse effects on producers and exporters in the rest of the world'. Interestingly, the Arbitrator observed that these trade effects and not the welfare effect of the GSM 102 programme were relevant for calculating the appropriate amount of countermeasures (see below Part II, Chapter 5, Section 5.1.3.1.2). Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, para 4.183.

[34] For the same subsidy level (S) in Figure 2 and Figure 3, its world price depressing effect ($P_W - P'_W$) is larger in the export subsidy scenario (Figure 2) than in the production subsidy scenario (Figure 3).

[35] The total welfare effect to the rest of the world of export subsidies and production subsidies are represented by area (+c*, +d*, +e*; Figure 2) and area (+c*, +d*, +e*; Figure 3) respectively.

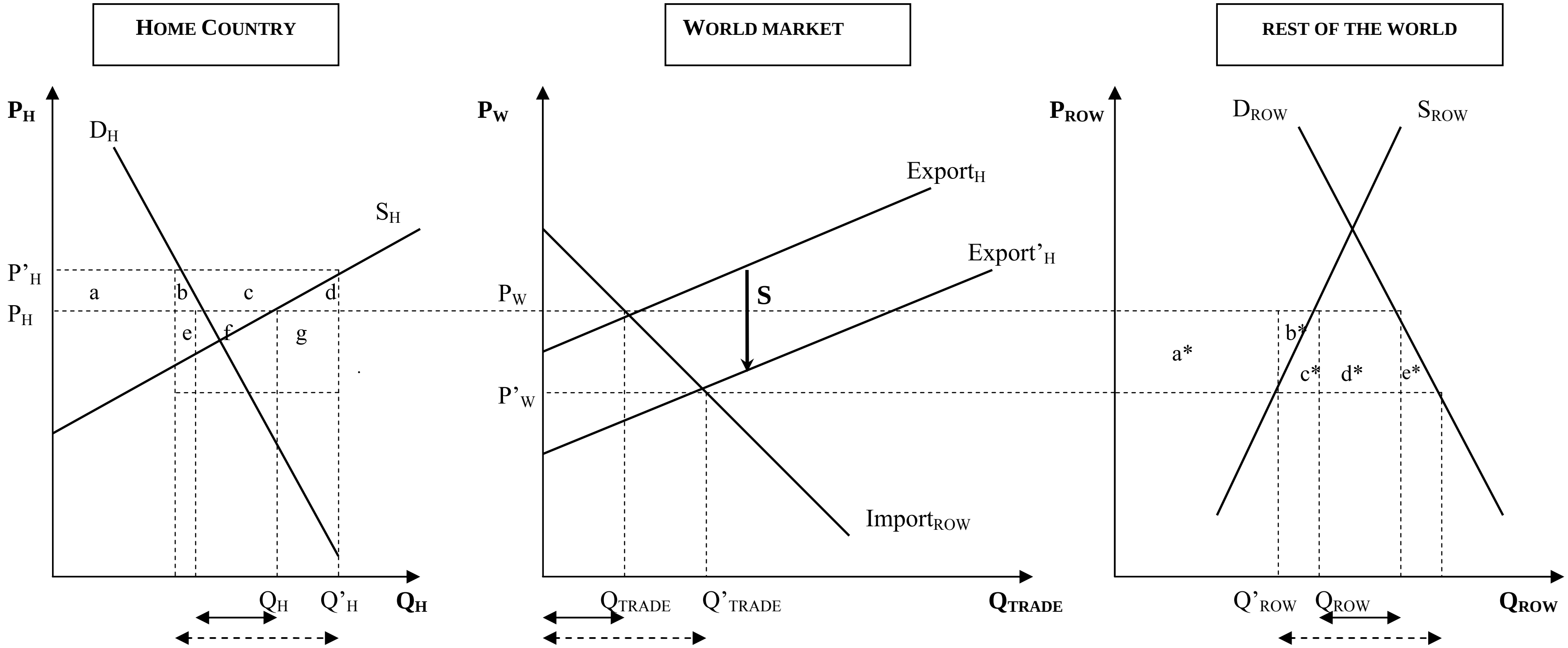
[36] Here, consumption and production distortions in the exporting and importing markets are thus created and world welfare decreases as a result of this efficiency loss. The effect on world welfare of the export subsidy and production subsidy are represented by area (-b, -d, -e, -f, -g, +c*, +d*, +e*) in Figure 2 and area (-c, -f, -h, -i, +c*, +d*, +e*) in Figure 3 respectively, which are both certainly negative.

[37] The welfare effect upon the subsidizing country is the sum of (+ a, +b, +c, -h) in Figure 4.

competitive market aims at maximizing its national welfare.[38] Moreover, the welfare effect upon the rest of the world is clearly negative as it absorbs a negative terms of trade effect and global world welfare would also be reduced because of inefficiency losses.[39]

[38] Whereas a domestic instrument is optimal to correct a domestic distortion, a trade instrument (tariff or export tax) is optimal to correct this international distortion (see above n 31). J. N. Bhagwati and V. K. Ramaswami, 'Domestic Distortions, Tariffs and the Theory of Optimum Subsidy', 71:1 *The Journal of Political Economy* (February, 1963), 44-50; Yeh, above n 24, at 89-92. Yeh has shown that a tariff is superior to a production subsidy for large countries when the degree of protection wanted for the import competing industry is not greater than the protection obtained under the optimal tariff. For higher levels of protection, Aiello has shown that tariffs remain optimal if the desired level is not too high, while a subsidy is preferred for larger quantities. He refers to non-economic rationales explaining why a country might be interested in providing a higher level of protection, namely political-economy reasons or food security (see below Part I, Chapter 3). F. Aiello, 'Ranking Production Subsidies and Import Tariffs under Different Scenarios', 9 *Applied Economics Letters* (2002), 715-720.

[39] The welfare effect upon the rest of the world is represented by area (-c*) in Figure 4 and the effect on world welfare is (-c*, -h, +a, +b, +c) in Figure 4, which is clearly negative.



Δ consumer surplus = -a, -b
Δ producer surplus = +a, +b, +c
Δ gvm revenue = -b, -c, -d, -e, -f, -g
+

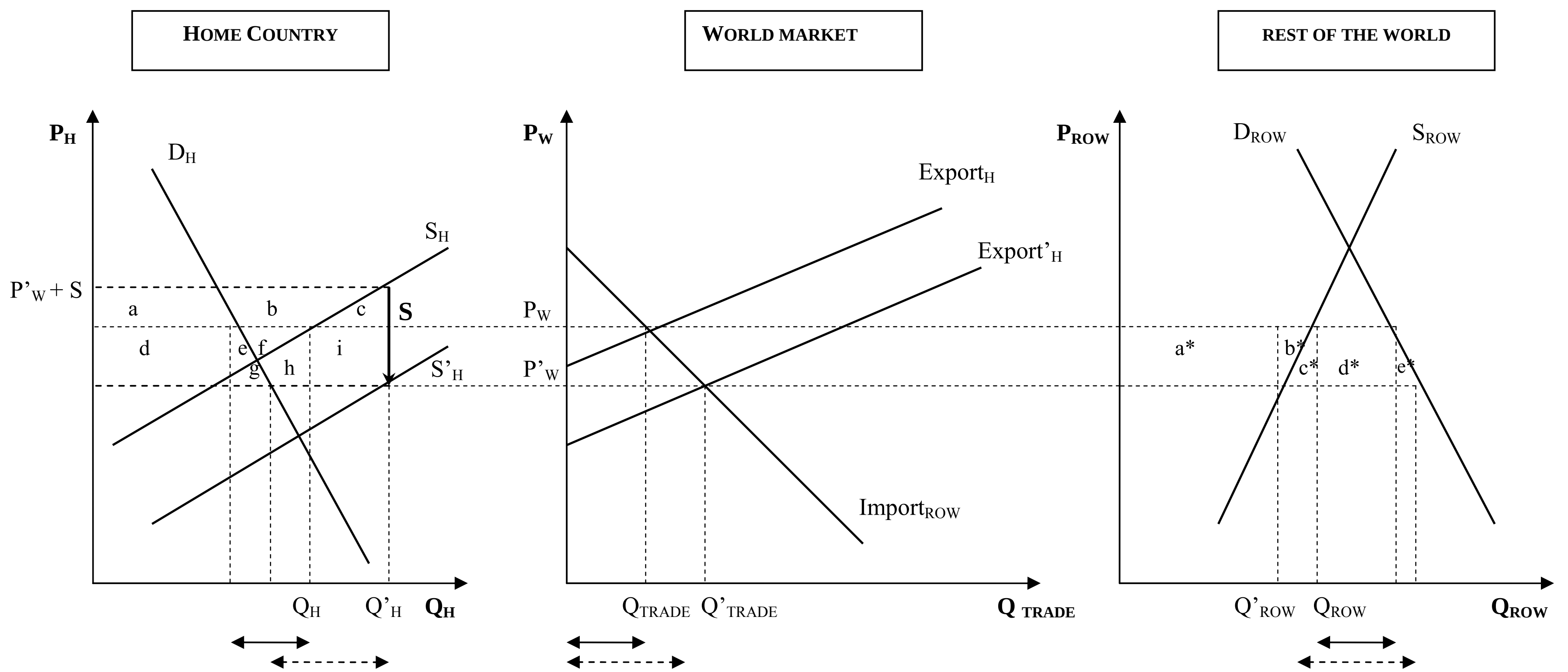
Δ total welfare $_{\text{HOME}}$ = -b, -d, -e, -f, -g

S = subsidy per unit export
Trade level before subsidy = Q_{TRADE} (⟷)
Trade level after subsidy = Q'_{TRADE} (⇠⇢)
World price before subsidy = P_W
World price after subsidy = P'_W
Home price after subsidy = P'_H
Δ total welfare $_{\text{WORLD}}$ = -b, -d, -e, -f, -g +c*, +d*, +e* < **0**

Δ consumer surplus = +a*, +b*, +c*, +d*, +e*
Δ producer surplus = -a*, -b*
+

Δ total welfare $_{\text{ROW}}$ = +c*, +d*, +e*

FIGURE 2: WELFARE EFFECTS OF EXPORT SUBSIDY BY LARGE HOME COUNTRY



Δ consumer surplus = +d, +e, +g
Δ producer surplus = +a, +b
Δ gvm revenue = -a, -b, -c, -d, -e, -f, -g, -h, -i
\+

Δ total welfare $_{HOME}$ = -c, -f, -h, -i

S = subsidy per unit production
Trade level before subsidy = Q_{TRADE} (⟷)
Trade level after subsidy = Q'_{TRADE} (⟵----⟶)
Price before subsidy = P_W
Price after subsidy = P'_W
Δ total welfare $_{WORLD}$ = -c, -f, -h, -i ,+ c*, +d*, +e* < **0**

Δ consumer surplus = + a*, +b*, +c*, +d*, +e*
Δ producer surplus = -a*, -b*
\+

Δ total welfare $_{ROW}$ = +c*, +d*, +e*

FIGURE 3: WELFARE EFFECTS OF PRODUCTION SUBSIDY TO EXPORT-COMPETING INDUSTRY BY LARGE HOME COUNTRY

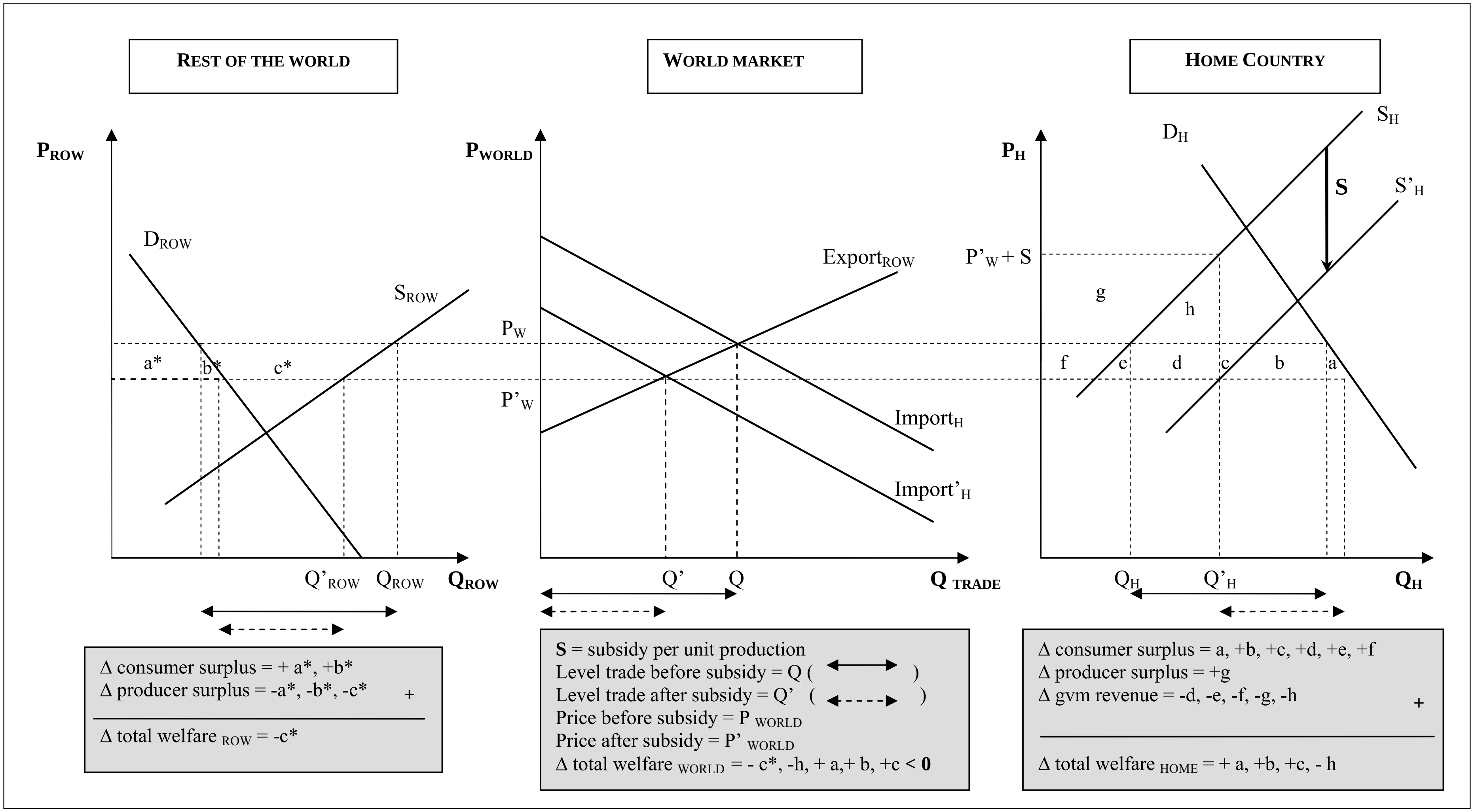


FIGURE 4: WELFARE EFFECTS OF PRODUCTION SUBSIDY TO IMPORT-COMPETING INDUSTRY BY LARGE HOME COUNTRY

1.3. WELFARE EFFECTS OF THE IMPOSITION OF COUNTERVAILING DUTIES

Even though the previous analysis has shown it has it no economic underpinning under the perfect market assumption, suppose one large country nonetheless offers a subsidy to its export-competing industry which depresses the world market price. Should third importing countries react by imposing countervailing duties?[40]

The welfare improving effect on net-importing countries is the reason why these countries were once advised by Krugman to send a thank you note to the subsidizing country's embassy instead of imposing countervailing duties upon importation of its subsidized goods.[41] Nevertheless, assume that producers convince their governments to impose CVDs in order to offset the price effect of the subsidy in the importing market and thus to 'level the playing field' on the domestic market.[42] Here again, the distinction between large and small countries should be made, because CVDs imposed on subsidized imports by the former depresses the world price as world demand falls.[43] In case CVDs by a large country offset the price effect of an export subsidy in the importing country, the distortion created by the subsidy will be fully eliminated and world welfare would return to the pre-subsidy, free trade level.[44] The

[40] By definition, CVDs can only be imposed upon imports. A subsidy to exporters in *small* countries will not affect the world price and foreign producers will therefore unlikely request for CVDs and, in the absence of injury to their domestic industry, no CVDs could legally be imposed (see below Part II, Chapter 5, Section 5.2.2.). Nonetheless, Sykes demonstrates that in case a subsidy is given to exporters with no effect on their output level (see above n 23), a CVD by one country will have no effect as subsidized exports will be redirected at another source and the country in question will import from another source. But if all countries impose CVDs, the subsidized exporters will be unable to circumvent it and the welfare in the CVDs-imposing countries will improve by the amount of the revenue from the duty (at the expense of the exporters). Sykes, above n 23, at 329-330.

[41] Cited in A. O. Sykes, 'Subsidies and Countervailing Measures', in P. F. J., Macrory, A. E., Appleton, M. G., Plummer (eds), *The World Trade Organization: Legal, Economic and Political Analysis* (Heidelberg: Springer Verlag, 2005) vol. 2, 83-107, at 92. Trebilcock even suggests that they should express 'their regret that the subsidies are not larger and timeless' in their thank you note. M. J. Trebilcock, 'Is the Game Worth the Candle: Comments on A Search for Economic and Financial Principles in the Administration of US Countervailing Duty Law', 21 *Law & Policy in International Business* (1990), 723-737, at 729.

[42] The CVDs will bring consumer and producer surplus back to their original pre-subsidy level in the importing country. Given that the benefits of a subsidy to consumers outweigh the losses upon producers, such CVDs thus result in a net loss to the sum of consumer and producer surplus. Except for the optimal tariff exception, the revenue collected by the government from imposing CVDs will certainly not fully compensate this net loss because of the deadweight loss triangles.

[43] Because of this terms of trade effect, the level of CVDs needed to return to the pre-subsidy price level in the importing countries is larger in the large country case than in the small country case.

[44] In case CVDs respond to *production subsidies,* the distortion generated by the subsidy is not fully neutralized. The importing country can return to the pre-subsidy level and neutralize the distortion by imposing CVDs. Yet, because in case of production subsidies the level of subsidies is larger than the CVDs which only neutralize the price effect in the importing country, production in the subsidizing country does not fall back to the pre-subsidy level and consumers in that market benefit from a further depressed price (induced by CVDs). Next to a transfer from subsidizing to importing governments (channelled via producers), a distortion in the subsidizing country is thus present. K. Baylis, 'Unfair subsidies and countervailing duties', in W. Kerr and J. D. Gaisford (eds), *Handbook on International Trade Policy* (Cheltenham: Edward Elgar, 2007), 347-360, at 349; WTO Secretariat, *World Trade Report 2009 – Trade Policy Commitments and Contingency Measures* (Geneva: WTO Publications, 2009), 171 pp., at 91.

only difference with the free trade situation is that welfare (in this case the full amount of the subsidy) is channeled via producers (collecting export subsidies in their home country and paying CVDs in the importing country) from the subsidizing country to the importing country.[45] Welfare in the importing country is thus definitely greater than under the free trade situation but whether it also outweighs the situation where the export subsidies are not responded to by CVDs depends on the relative importance of the distortion introduced by the CVDs (deadweight loss triangles) compared to the positive terms of trade effect.[46] Parallel to the 'optimal tariff' theory, if a country is sufficiently large, the terms of trade benefit generated by CVDs could potentially more than compensate for the efficiency losses and could thus improve the welfare of the importing country even further.[47] If so, the tariff revenue resulting from collecting CVDs is larger than the net loss to consumers and producers which results from countervailing the subsidy.[48]

Yet, three arguments cast doubt on the relevance of this scenario.[49] First, if the deterrence effect of CVDs leads to the withdrawal of the subsidy,[50] the beneficial terms of trade effect of both the foreign subsidy and the CVDs – that in turn will have to be cancelled – vanish.[51] Welfare in the importing country would fall back to the lower pre-subsidy level. Second, the information required on demand and supply to decide whether CVDs will effectively be welfare improving might be too demanding.[52] On the other hand, CVDs imposed by *small* countries will certainly reduce their welfare as they could not affect the terms of trade and

[45] World Trade Report 2009, above n 44, at 89.

[46] The deadweight or efficiency loss represents the fact that consumers pay a higher price, while the marginal cost of production is higher than the price of (subsidized) imports in case CVDs are imposed. The picture is somewhat more complicated if third countries are included in the model. If demand in other markets is sufficiently elastic, producers faced with CVDs imposed by one country might simply shift exports to these markets, which would result in a welfare decline in the country imposing CVDs (no revenue from the CVDs is collected and net decline in the sum of consumer and producer surplus). But if not all exports are redirected to other markets (e.g., because demand in those markets is inelastic), the CVDs-imposing country's welfare might improve in case the revenue from the CVDs offsets the net decline in the sum of consumer and producer surplus. Sykes, above n 23, at 323-326.

[47] The terms of trade benefit thus implies that some of the revenue collected by the government is not extracted from domestic consumer surplus (paying a higher price) but from foreign producer surplus (producers absorb part of the duty on the products they continue to import) (see above n 31). In contrast to a small country, the full amount of the duty is not absorbed by domestic consumers. The less elastic the import supply curve (i.e., the less sensitive foreign producers are to a change in import price), the larger the part is that is extracted from foreign producers and the less CVDs are thus welfare reducing. A. O. Sykes, 'Second-best countervailing duty policy: A critique of the entitlement approach', 21 *Law & Policy in International Business* (1990), 699-737, at 705-706; Sykes, above n 6, at 110.

[48] As the benefits of subsidization to consumers outweigh the loss upon producers, CVDs canceling these effects indeed generate a net loss to the sum of consumer and producer surplus.

[49] Sykes, above n 23, at 331.

[50] In the example elaborated in the full text, this will likely happen as the full amount of the subsidy is channelled to the foreign government.

[51] Of course, the large importing country could still impose an ordinary customs duty as an optimal tariff but can only do so if this level is not above its bound level of commitments under Article II of the GATT.

[52] This argument also casts doubt on the practical use of the general 'optimal tariff' argument.

could therefore not compensate the efficiency loss from the duty. Because the terms of trade is unaffected, the level of CVDs needed to return to the pre-subsidy price level in the importing countries is smaller in the small country case than in the large country case and only part of the subsidy will be channelled to the small country if it imposes CVDs.[53] Hence, except for the 'optimal CVDs' scenario for large countries, a countervailing duty would be welfare depressing under perfect market assumptions and consequently make the importing country worse off compared to the situation where it does not react against the subsidized imports.[54] Third, the narrow focus on terms of trade improvements in the welfare analysis neglects that, from a dynamic perspective, trade protective measures such as CVDs might very well inhibit productivity improvements in the importing country.[55]

Turning to the perspective of world welfare and net-exporting countries, CVDs might be justified if they succeed in deterring subsidization, given that subsidies reduce world welfare and net-exporting countries' welfare under perfect market conditions.[56] This is called the 'deterrence' or 'global efficiency' rationale for CVDs: CVDs (or threat thereof) simply deter other countries from offering global welfare reducing or 'inefficient' subsidies. Yet, in order for this deterrence effect to be present, two conditions should at minimum be fulfilled. First, only CVDs imposed by large countries and thus generating a terms of trade effect could potentially deter subsidization as they negatively affect the output of the subsidized importing

[53] World Trade Report 2009, above n 44, at 89.

[54] Consumers pay a higher price and the marginal cost of production is higher than the price of (subsidized) imports in case CVDs are imposed. CVDs thus reduce welfare of the net-importing country even if the subsidy is not withdrawn (except for the large country exception).

[55] Estimating the effect of anti-dumping duties on the productivity of domestic import-competing firms, Konings and Vandenbussche have found that this moderately improves on average, but in an insufficient way to close the productivity gap with firms not involved in anti-dumping cases. Therefore, they conclude that trade protection is a poor instrument to spur average firm-level productivity. Moreover, whereas domestic firms with *low* initial productivity levels have productivity gains, firms with *high* initial productivity levels (i.e., frontier firms) experience productivity losses during protection. Hence, Konings and Vandenbussche argue that this productivity drop of frontier firms is an additional cost of protection that should be added to the loss in consumer surplus and the sub-optimal level of exit resulting from protection. See J. Konings and H. Vandenbussche, 'Heterogeneous Responses of Firms to Trade Protection', 76 *Journal of International Economics* (2008), 371-383.

[56] Standard models mostly assume that a country is either an importer or exporter of a certain product, which implies that (i) besides the large country exception, CVDs are always welfare reducing because a country imposing CVDs does by definition not export; (ii) exporting countries could also by definition not impose CVDs so as to deter subsidization and thus, indirectly, offset their harm in third countries. Of course, such an exporting country would benefit from CVDs deterring subsidization imposed by importing countries, which would act against their own welfare. Nonetheless, a country could be an importer as well as exporter of the same product, for example, because of the existence of transport costs. If CVDs result in the abolishment of the export subsidies, prices may increase in third markets and hereby benefit exporters. Sykes, above n 23, at 323; World Trade Report 2009, above n 44, at 90.

producer.[57] Second, the level of CVDs should at minimum reach the level of the benefit received from the subsidy to deter subsidization.[58] As will be covered below, the 'entitlement' school rejected this 'deterrence' or 'global efficiency' rationale as an explanation to why the US imposed CVDs. From a normative viewpoint, the 'deterrence' or 'global efficiency' rationale could potentially justify why CVDs should be allowed under multilateral trade rules.[59]

1.4. SUBSIDIES AS A TOOL FOR SHIFTING COMPARATIVE ADVANTAGE

Under the perfect market assumption, no argument can be made for subsidizing domestic industries in order to alter the pattern of trade. Reflecting upon the concern in the 1980s that foreign targeting (mainly by Japan) of US industries would harm the US, Krugman wondered why high-technology sectors should be treated any differently than other sectors: 'What, if anything, makes the production of computers a more desirable activity at the margin than production of textiles?'[60] To borrow an example by Dixit who refers to a statement wrongly attributed by Samuelson to Abraham Lincoln: 'When I buy a coat from England, I have the coat and England has the money. But when I buy a coat in America, I have the coat and America has the money'.[61] Transposed to the debate of today, 'England' could be better replaced by 'China' in this example. As Dixit highlights, the quote fails to recognize that it would require labor and capital input to produce this coat in the US and that the US would thus lose the opportunity to deploy these inputs in another and maybe more efficient way.[62] Hence, would the US be better off by producing the coat itself instead of importing it from China? If China has a lower opportunity cost of producing coats in terms of computers and thus has a *comparative* advantage in producing coats, the answer is simply 'no'.[63] The law of comparative advantage explains *why* Lincoln today would import its coat from China and export computers to China (positive aspect) and shows *how* this makes both countries better off or at least no country worse off (normative aspect; Pareto improvement). A coat

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[57] See, for example, J. H. Jackson, 'Perspectives on Countervailing Duties', 21 *Law & Policy in International Business* (1990), 739-769, at 744.
[58] See R. Diamond, 'A Search for Economic and Financial Principles in the Administration of United States Countervailing Duty Law', 21 *Law & Policy in International Business* (1990), 507-608, at 525.
[59] See below Part IV, Chapter 4.
[60] P. Krugman, 'The US Response to Foreign Industrial Targeting', 1984:1 *Brookings Papers on Economic Activity* (1984), 77-131, at 106.
[61] Dixit, above n 6, at 287.
[62] Assuming the option of producing two types of goods (coats or computers), the opportunity cost of producing one extra coat is the number of computers that could have been produced with the resources/inputs used to produce this coat. More generally, the opportunity cost of producing a product is the value of the best alternative which could have been produced with the same amount of inputs.
[63] How can we know that China has a comparative advantage in producing coats? The Ricardian one-factor model points to differences in labor productivity (output per worker), whereas the multi-factor Heckscher-Ohlin model explains trade in terms of differences in relative resource endowments (quantities of land, labor, capital, and entrepreneurs) between countries.

(computer) costs the US (China) less in terms of computers (coats) if imported than if produced domestically. In Krugman's clear-cut words, 'an export is an indirect way to produce an import, which is worth doing because it is more efficient than producing our imports ourselves'.[64] The static welfare benefit of trade opening results from countries' specialization in what they do relatively best (reallocation of resources), whereas market forces automatically lead to such specialization if trade is opened.[65] If markets function perfectly, the Lincoln of today will and should therefore import coats from China in exchange for computers. From a static welfare perspective, no argument can thus be made to support the local production of coats (computers) in the US (China) by subsidization or trade barriers.[66] If China (the US) would nonetheless target the computer (coat) sector, the US (China) would incur a terms of trade loss as a net-exporting country.[67,68]

64 P. Krugman, 'Making sense of the competitiveness debate', 12:3 *Oxford Review of Economic Policy* (1996), 17-25, at 19.

65 Given that no economies of scale are assumed (opportunity costs are constant), benefits of trade do not result from market expansion in these traditional trade models.

66 As elaborated, an optimal tariff (or production subsidy as second-best alternative) could be welfare improving for large countries, but its objective is not to set up local production. See also G. M. Grossman, 'Promoting New Industrial Activities: a survey of recent arguments and evidence', 14 *OECD Economic Studies* (Spring, 1990), 87-125, at 93-94.

67 In the two-country, two-goods model, both countries are assumed to be large. Krugman indeed found that US terms of trade had deteriorated during the 1960s-1970s but this would have had just a small effect on real income and could certainly not be completely attributed to foreign industrial policies. Therefore, he concluded that any serious adverse effect from foreign targeting should be occurring through channels other than the terms of trade. Krugman, above n 60, at 85-87. Dixit and Grossman even observed that since the 1990s, the US terms of trade has been steady or perhaps even improved. A. Dixit and G. Grossman, 'The Limits of Free Trade', 19:3 *Journal of Economic Perspectives* (Summer 2005), at 241-242.

68 If the rise in labor productivity resulting from subsidization (or likewise, if it does not result from subsidization) occurs in the US exporting sector (computers) and up to the level at which the relative labor productivity of computers in China matches that of the US, all static benefits of trade would vanish and US welfare would fall back to the level of autarky as the opportunity cost of a coat would equal its relative world price. This 'worst-case scenario' was elaborated in a controversial article of Samuelson, in which he more generally demonstrated that a foreign productivity gain (e.g., in China) in the US' exporting sector depresses the static gains from trade to the US But Dixit and Grossman correctly emphasized that Samuelson simply proved that such productivity gain in China would depress the US terms of trade (for which they found no evidence in practice, see above n 67) and that free trade remains optimal for the US under the situation that productivity has improved in China (only in the worst case scenario the US that would be indifferent on whether or not to trade). Indeed, if China turns out to be relatively more productive than the US in producing computers (compared to producing cloths), the US would benefit from importing computers (and exporting cloths). P. A. Samuelson, 'Where Ricardo and Mill Rebut and Confirm Arguments of Mainstream Economists Supporting Globalization', 18:3 *Journal of Economic Perspectives* (Summer 2004), 135-146; Dixit and Grossman, above n 67, at 241-242.

2. ECONOMIC RATIONALES FOR SUBSIDIES AND COUNTERVAILING DUTIES IN THE PRESENCE OF MARKET FAILURES

Why do governments in practice subsidize and impose CVDs even if welfare theory teaches that this contracts their own country's welfare under the perfect market assumption? These government interventions can be explained if the perfect market assumption does not hold. In reality, markets indeed often fail to reach a Pareto optimal outcome in case they are imperfectly competitive or incomplete. For the purpose of the present study, five broad categories of market failures could be highlighted. First, the market itself might function imperfectly (e.g., monopoly or oligopoly) in a way that firms are not price takers but have some market power to set the price above marginal costs.[69] Such imperfectly competitive markets thus generate insufficient output at an inflated price, which is a Pareto inefficient outcome.[70] Second, even if markets are perfectly competitive so that the market price equals the marginal cost of production, this market price may not reflect all benefits or costs to society and thus deviate from the 'socially optimal price'. Positive or negative externalities (also called 'spillovers') are, respectively, benefits or costs resulting from consumer or producer actions that are not reflected in the market price and, thus, external to the market. Such marginal external benefits or costs can be internalized by government intervention in a way that the new market price equals the socially optimal price. Third, for 'public goods', no private market develops because these goods can be made available at low or no additional costs to extra consumers (nonrival) and cannot be shielded away from additional consumption (nonexclusive). As consumers cannot be excluded ('free rider problem'), no private market offering these public goods will emerge on itself.[71] Fourth, 'complementarities' ('substitutes') as a particular type of externalities exist when an action of one economic actor does not only have a positive or negative externality on other actors but, at the same time, increases (decreases) the incentive of other actors to act similarly.[72] If such complementarities are pervasive, the market might get stuck in a Pareto sub-optimal equilibrium because economic actors fail to coordinate their actions (coordination failure). Fifth, an information failure is present if economic actors dispose of incomplete information to make decisions that would lead to an efficient allocation of resources. Or, in some markets (e.g., capital markets) information might also be asymmetrically available among producers and consumers, which again, could prevent these markets from operating efficiently.

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[69] For example, a monopolist maximizes profit by choosing an output level where marginal costs equal marginal revenue. The corresponding price is higher than marginal costs.

[70] The marginal benefit to consumers is higher than the marginal costs to producers. Put otherwise, the value to consumers of additional output exceeds the cost of producing it.

[71] One could also look at certain 'positive externalities' (e.g., clean air, knowledge) as having some public goods characteristics: these positive side-effects of the product in question are enjoyed by other actors at no additional costs and/or these actors could not be excluded from its consumption.

[72] D. Ray, *Development Economics* (Princeton: Princeton University Press, 1998), 848 pp., at 114-116.

In the presence of such market failures, the Pareto-efficient outcome does not result from market forces but requires government intervention. Of course, government intervention does not guarantee that a Pareto optimal outcome will be reached. To this end, governments should intervene in an effective way and tackle the market failure as directly as possible and choose the appropriate instrument (e.g., some type of subsidy, tax, regulation) thereto (targeting principle).[73] In case of a non-effective strategy, the government intervention leads to distortions in other markets.[74] Yet, this assumes that these other markets are functioning properly and that correcting the market failure directly is not unfeasible for political or other reasons. If not, the theory of the second-best applies: governments have to take recourse to a second-best option to solve the market failure by intervening in other segments of the economy, but only insofar the benefits of correcting the market failure still outweigh the costs that result from the creation of new distortions in those other segments (cost-benefit analysis).[75] As illustrated below, if a domestic market failure occurs (e.g., inflexible labor market), a trade policy response (e.g., CVDs) is at most a second-best option because a new distortion is created. Domestic distortions should in principle be corrected by domestic instruments (e.g., taxes or subsidies on domestic consumption, production or input factors) and not by trade instruments (e.g., tariffs, export taxes or export subsidies).[76] In general, if domestic production is too low because of a domestic market failure, a production subsidy is superior to an import barrier or export subsidy as the latter also negatively affect consumers in the domestic market.[77] Equally, a production or output subsidy is an optimal instrument only in case the externality is directly linked (or fixed) to the level of production.[78] If not, a policy intervention directly targeting the market distortion would in principle be more suited on efficiency grounds. From a national and world welfare perspective, all countries in which

[73] J. N. Bhagwati, 'The Generalized Theory of Distortions and Welfare', in J. N. Bhagwati (ed), *International Trade: Selected Readings*, 2 ed. (Cambridge: The MIT Press, 1987), 265-286.
[74] See also Corden, above n 24, at 28-31.
[75] For an overview of papers dealing with second best interventions, see P. Krishna and A. Panagariya, 'A Unification of Second Best Results in International Trade', 52 *Journal of International Economics* (2000), 235–257.
[76] Bhagwati and Ramaswami, above n 38, 44-50; H. G. Johnson, 'Optimal Trade Intervention in the presence of Domestic Distortions', in J. N. Bhagwati (ed), *International Trade: Selected Readings*, 2 ed. (Cambridge: The MIT Press, 1987), 235-263.
[77] J. J. Barceló, 'Subsidies and Countervailing Duties – Analysis and Proposal', in Robert Howse (ed), *The World Trading System: Critical Perspectives on the World Economy – Volume 3 – Administered Protection* (London: Routledge, 1997), 252-314, at 259; Bagwell, above n 25, at 25. This statement is certainly correct for small countries, which cannot affect the terms of trade, but might have to be nuanced for large countries in case only one instrument could be used. Surely, a production subsidy is still superior to correct the domestic distortion but a tariff is optimal to correct the 'foreign' distortion (e.g., to induce a positive terms of trade effect). Indeed, a production subsidy to the import competing industry also positively affects the terms of trade but Yeh has shown that, in the absence of domestic market failures, tariffs are optimal to this end (see above n 38). If both cannot be applied at the same time, there seems to be no clear-cut ranking on the option that should be preferred.
[78] Grossman, above n 66, at 118.

distortions are present are advised to adopt corrective measures (e.g., subsidies). Conversely, countries in which such distortions are not displayed should not intervene, even though they might be confronted with corrective measures (e.g., subsidies) abroad and might thus claim that the playing field is not level.[79]

In the following section, the aforementioned types of market failures and the potential role of subsidization and CVDs are illustrated.[80] First, strategic trade theory has shown that by subsidization, governments could shift foreign profits to domestic firms that operate in oligopolistic markets (Section 2.1). Hereby, the government aims at exploiting the market failure imperfection rather than correcting it. The latter is in principle the objective of a country's industrial policy, which could be defined broadly as all government measures attempting to speed or alter the process of resource allocation among or within industrial and service sectors with the aim of correcting market distortions that inhibit economic growth.[81,82] Second, the role of subsidies as well as CVDs as corrective instruments in case of labor market imperfections are assessed from the perspective of both developed and developing countries (Section 2.2). Further, the discussion will turn to market failures that typically function on the agenda of industrial policies in developed countries and developing countries respectively. A third section addresses Research and Development (R&D) subsidies allocated so as to stimulate knowledge generating activities, as an important tool of industrial policy mainly used in developed countries who have their comparative advantage in technology-intensive sectors (Section 2.3). Fourth, the much debated role of corrective industrial policies in developing countries is analyzed in the subsequent (Section 2.4). Indeed, it is generally acknowledged that some types of market failures, such as information or coordination failures, are more pervasive and widespread in developing countries. To be clear, the option of analyzing different types of market failures from different angles (namely, the angles of developed and developing countries, respectively), does not mean that the market failure in question is not relevant for the industrial policy agenda of the other group of countries but simply illustrates its case from the most important angle. Finally, the global economic recession (2009-10), rooted in market failures in the US housing and financial markets, called for government interventions in both developed and developing countries, often taking the

[79] See also A. V. Deardoff, 'Economic Effects of "levelling the playing field" in International Trade', *RSIE Discussion Paper* No. 289 (July 2009), 42 pp., at 20.
[80] Obviously, only an illustrative list of potential market failures is offered, which is far from exhaustive. The focus is on those market failures that might call for subsidization and/or CVDs as optimal or second-best solutions.
[81] This definition is partly derived from D. Rutherford, *Routledge Dictionary of Economics*, 2nd ed. (London: Routledge, 2002), 671 pp., at 270.
[82] Of course, it could also be argued that strategic trade policy could be part of a country's industrial policy. For a broader discussion on the concept of 'industrial policy', see below n 243.

form of subsidies in its broad meaning (Section 2.5). Corrective governmental policies which are strictly speaking not motivated on the basis of static welfare or economic growth considerations (e.g., environmental protection) are discussed under Chapter III.[83]

2.1. SUBSIDIES AND CVDS AS STRATEGIC TRADE POLICY INSTRUMENTS

In some markets such as aircraft[84], barriers to entry (e.g., large fixed costs) have as a result that only a limited number of firms account for most or all production because a sufficient high level of production is required to recover these initial costs.[85] In such oligopolistic markets, individual firms are not price takers as under perfect competition but set output (Cournot model[86]) or price levels (Bertrand model) taking into account output and price decisions by competitors.[87] Hence, profits of one firm are directly affected by strategic decisions of its competitors.[88] The central insight of strategic trade theory, which developed since the 1980s, is that governments' trade policy can alter this strategic interaction between firms in a way that national welfare is optimized.[89] Hereby, governments do not intervene to correct market imperfections as a central policy motive of industrial policy, but to strategically shift profit from foreign competitors to domestic firms.

2.1.1. Subsidies as strategic trade instrument

Whereas no case can be made for subsidies under the perfect market assumption, Brander and Spencer have shown that a welfare maximizing country should provide export subsidies to

[83] With the term 'economic rationales' as used in this first Part's title, I refer to arguments for subsidization from the perspective of welfare (static) or economic growth *sensu stricto* (dynamic). Environmental protection, as related to sustainable development arguments, is therefore not listed as an 'economic rationale'.
[84] Cline also refers to the steel and automobile industry. W. R. Cline, 'US Trade and Industrial Policy: The Experience of Textiles, Steel, and Automobile', in P. Krugman (ed), *Strategic Trade Policy and the New International Economics* (Cambridge: The MIT Press, 1986), 211-239. See also K. Bagwell and R. W. Staiger, *The Economics of the World Trading System* (Cambridge: The MIT Press, 2002), 224 pp., at 169, n 5.
[85] These barriers to entry might be related to the market (e.g., economies of scale or access to technology) or strategic actions by incumbent firms deterring entry (e.g., threat to flood the market).
[86] The Cournot model is an oligopoly model with the following features: (i) firms produce an identical good; (ii) each firm treats the output of its competitors as fixed; and (iii) all firms decide simultaneously how much to produce. See R. S. Pindyck and D. L. Rubinfeld, *Microeconomics*, 5th ed (London: Prentice Hall International, 2001), 700 pp., at 431
[87] Notice that producers in oligopolistic markets are by definition operating in a large country.
[88] Of course, competitors should be aware that they have a strategic relationship (playing a strategic game). This is thus not the case under perfect competition (firms are price takers and do not make profit) or under pure monopoly, unless potential entry of other firms is an important consideration (see below n 94). Strategic interaction is also typically absent in case of monopolist competition. See J. A. Brander, 'Strategic Trade Policy', in G. M. Grossman and K. Rogoff (eds) *Handbook of International Economics – Volume 3* (Amsterdam: North-Holland, 1995), 1395-1455, at 1397.
[89] Strategic trade policy is defined by Brander as 'trade policy that conditions or alters a strategic relationship between firms'. Brander, above n 88, at 1397. Targeting sectors generating national R&D spillovers is therefore not considered as a strategic trade policy. Of course, R&D subsidies could be used as strategic trade policy instruments (see below Part I, Chapter 2, Section 2.3).

firms operating in oligopolistic markets if these firms behave as Cournot competitors.[90] A firm operating in a Cournot type of oligopolistic model sets its output at a profit-maximizing level given the quantity produced by competitors (Nash equilibrium). The more it assumes that competitors will produce, the less it will produce itself (downward sloping reaction function). In the Cournot equilibrium, an example of a Nash equilibrium, no firm can increase its profits by changing output given the output produced by its competitors. In this equilibrium, firms are making true profit ('economic profit'; price is higher than average costs) and total output is less than under perfect competition and thus below the Pareto efficient level (oligipolistic distortion). This 'market failure'-feature of oligopolistic markets has important consequences for the design of trade policy. Indeed, Brander and Spencer have demonstrated that a country could shift a larger share of profitable output from foreign competitors to domestic firms by subsidizing domestic exports. The export subsidy commits domestic firms to a higher level of exports,[91] resulting in a reaction by foreign competitors to contract their output.[92] Given that the profit gain to domestic firms (expanded output and market share at a price above average costs) is larger than the subsidy amount (or the negative terms of trade effect), net welfare of the subsidizing country increases.[93] In addition, total output also increases, resulting in lower world prices to the benefit of importing countries. On the other hand, exporting countries are hurt as profitable output is shifted away from their firms. Accordingly, such strategic trade policy has a beggar-thy-neighbour element: the subsidizing country's welfare increases but at the expense of other exporting countries' welfare. The change in total world welfare of this profit-shifting export subsidy is nonetheless positive because the oligipolistic distortion shrinks: the world price lowers and output increases, both coming closer to the competitive equilibrium.[94,95] In conclusion, this

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[90] J. A. Brander and B. J. Spencer, 'Export Subsidies and International Market Share Rivalry', 18 *Journal of International Economics* (1985), 83-100.

[91] The subsidy lowers marginal costs of the domestic firm and thus shifts it to a higher reaction function.

[92] In the model, which assumes that there is no domestic consumption (third-market model), governments act first (play Stackelberg against firms) by setting subsidy levels before (one foreign and one domestic) firms simultaneously decide on output levels (play Nash against each other and against governments). The government has to precommit itself to a certain subsidy level even if it would turn out suboptimal once firms decide on output levels. The new equilibrium resulting from the export subsidy corresponds to the equilibrium in absence of the subsidy whereby the domestic firm would be the Stackelberg leader. In essence, the government is thus able 'to turn its first-mover advantage into an equivalent advantage to the domestic firm'. Brander, above n 88, at 1409. In the Cournot model, output levels are considered 'unfriendly' (lowering competitors' profit in total) and 'strategic substitutes' (lowering competitors' profit at the margin).

[93] The contribution of the subsidy to the profit of the domestic firm is offset by the subsidy cost to the government (transfer). Yet, the subsidy has an additional indirect positive effect on domestic firms' profit by lowering the output level of foreign firms. The subsidy's strategic effect on foreign firms' behaviour exactly explains the positive welfare effect in the subsidizing country. See also Krugman, above n 60, at 98-99.

[94] This is the case unless the subsidy drives foreign competitors out of the market (or deters entrance), turning the domestic competitor into a monopolist. Conversely, promoting new entrance in

Brander-Spencer model provides an economic rationale for welfare maximizing countries to subsidize output (as such or only exports) of firms operating in oligopolistic markets.[96] Because firms in these markets make profit, governments have an incentive to channel such profits from foreign to domestic firms by extending output subsidies (profit-shifting rationale). In the non-cooperative Nash equilibrium, both countries will offer export subsidies with the largest export subsidies given by the country with the most competitive firm.[97] Neary and de Meza have shown that the profit shifting potential of competitive firms is higher than that of cost inefficient firms because the former are more likely to gain market share. Governments should therefore subsidize winners more heavily.[98] This differs from the traditional infant industry theory prescription, which would suggest channeling subsidies to firms having high costs in the present but low costs in the future resulting from economies of scale (e.g., learning-by-doing) (see below).

Yet, the specific assumptions adopted in the Brander-Spencer model make export or general output subsidies not a robust policy recommendation for governments. First, the assumption that firms act like Cournot competitors seems crucial to make the model's 'profit-shifting'-claim. Eaton and Grossman have illustrated that if firms in the oligopolistic market compete on price instead of quantity (Bertrand competition instead of Cournot competition), the optimal policy would be an export tax rather than an export subsidy.[99,100]

oligopolistic or monopolistic markets might also lead to excessive entry from the viewpoint of achieving economies of scale. D. R. Collie, 'A Rationale for the WTO Prohibition on Export Subsidies: Strategic Export Subsidies and World Welfare', 11 *Open Economies Review* (2000), 229-245, at 230; D. Leahy, J. P. Neary, 'Multilateral Subsidy Games', 41:1 *Economic Theory* (October, 2009), 41-66, at 2. Brander is also sceptical that decentralized strategic trade policies will achieve outcomes that approach the world-level normative ideal. Brander, above n 88, at 1409.

[95] The analysis is similar in case of output or production subsidies not dependent on exportation as the model assumes that there is no domestic consumption in both exporting countries.

[96] Brander and Spencer have also demonstrated that subsidization remains optimal when firms are unionized under Cournot competition. J. A. Brander and B. J. Spencer, 'Unionized Oligopoly and International Trade Policy', 24:3-4 *Journal of International Economics* (May, 1988), 217-234.

[97] However, both countries would usually be better off if they cooperate to end subsidization (see below). D. De Meza, 'Export Subsidies and High Productivity: Cause or Effect?', 19:2 *The Canadian Journal of Economics* (May, 1986), 347-350; D. Collie, 'Profit-Shifting Export Subsidies and the Sustainability of Free Trade', 40:4 *Scottish Journal of Political Economy* (November, 1993), 408-419.

[98] J. P. Neary, 'Cost Asymmetries and International Subsidy Games: Should Governments help Winners or Losers?', 37 *Journal of International Economics* (1994), 197-218; de Meza, above n 97, at 347-350. An exception might have to be made for promoting *entrance* in monopolist or oligopolistic markets.

[99] The export tax commits the domestic firm to a higher price, hereby giving an incentive to foreign firms to set a higher price (price increases are thus considered as 'friendly'). Thus, the export tax is rather a promise than a threat. In contrast to Cournot competition, foreign firms therefore also benefit from the export tax and total global welfare is reduced (higher price and lower output compared to the competitive equilibrium). See J. Eaton and G. M. Grossman, 'Optimal Trade and Industrial Policy under Oligopoly', 101:2 *The Quarterly Journal of Economics* (May, 1986), 383-406, at 392-394; Brander, above n 88, at 1416.

[100] However, Bandyopadhyay et al have shown that if both firms are unionized, export subsidies become optimal under Bertrand competition (see also above n 96). S. Bandyopadhyay, S. C.

Second, the Eaton-Grossman model as well as the Brander-Spencer model assume that governments act before firms, whereas Carmichael has argued that, in case of fields such as official export credits, it is more realistic to assume that firms act first.[101] If firms set a price first ('stated price') and know that a subsidy programme is in place that keeps demand for exports[102] – and thus the 'effective price' – constant, they have an incentive to inflate their stated price so as to induce a higher subsidy. Indeed, a higher stated price forces the government to provide a higher subsidy if the effective price has to be kept constant. In Carmichael's view, this explains why export credit subsidies are offered. Hereby, governments do not act with a profit-shifting motive but merely react with a higher subsidy to a firm's rent seeking behavior expressed by an inflated stated price. In this game, welfare is simply shifted from governments (subsidy expense) to firms (higher profit). As Brander has observed, the strategic decision in this game is in fact the decision to set up a subsidy programme (e.g., export credit agency) in the first place.[103] If this step is considered separately, the case for non-intervention becomes more plausible. Hence, this literature shows that sequencing plays an important role in designing the optimal policy.

Third, even if the government acts first as the Brander-Spencer model assumes, it can only influence the strategic decision of competitors if it can effectively precommit itself to a certain level of subsidization. Thus, the government should be able to play the game and be recognized by competitors as a player. In practice, the government might lack the knowledge on the characteristics of the oligipolistic market to set an efficient level of subsidization or might lack credibility to commit itself to such subsidization (government failure).[104]

Fourth, the Brander-Spencer model only looks at the effect on the targeted industry (partial equilibrium model) and does not acknowledge the fact that expansion of the targeted industry as a result of the export (or other output) subsidy drains off resources from other industries (general equilibrium). Indeed, Dixit and Grossman have shown that profit-shifting subsidies to one oligopolistic industry might even cause a greater profit-extracting loss in other oligopolistic industries in case they compete for the same scarce production factor (e.g., highly skilled labor).[105] The subsidy raises the output of the supported oligopolistic industry

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Bandyopadhyay, and E. Park, 'Unionized Bertrand Duopoly and Strategic Export Policy', 8:1 *Review of International Economics* (2000), 164–174.

[101] C. M. Carmichael, 'The Control of Export Credit Subsidies and its Welfare Consequences', 23 *Journal of International Economics* (1987), 1-19.

[102] In this model, a negative export credit subsidy (i.e., export credit tax) is not considered an option.

[103] Brander, above n 88, at 1420.

[104] On the lack of adequate information, see P. R. Krugman and M. Obstfeld, *International Economics – Theory and Policy*, 6th ed. (Boston: Addison Wesley, 2003), 754 pp., at 280-281; see also, J. P. Neary and Dermot Leahy, 'Strategic Trade and Industrial Policy Towards Dynamic Oligopolies', 110 *The Economic Journal* (April, 2000), 484-508.

[105] If all other industries are perfectly competitive, no rents are lost by subsidizing the oligopolistic industry as it draws resources from industries where prices equal marginal costs. A. K. Dixit and G. M. Grossman, 'Targeted export promotion with several oligopolistic industries', 21:3-4 *Journal of*

but also increases the price of the scarce production factor and thus decreases the output of other oligopolistic industries. In principle, the government should therefore support the oligopolistic industry with the highest profit-shifting potential but this imposes even more demanding information requirements on the government.

Fifth, in line with general welfare theory, the Brander-Spencer model gives equal weight to welfare of consumers, producers, and governments. Thus, an extra dollar of profit for producers has the same value as an extra dollar in the government budget. In practice, however, the opportunity cost of public funds likely exceeds unity as these are often collected on the basis of distortionary taxation (i.e., if lump-sum taxation is not available).[106] Alternatively, giving government welfare relatively greater weight than producer profit might reflect the fact that subsidized domestic producers in question are in part foreign-owned and that the share of profit to these shareholders would not be incorporated in national welfare. Equally, it may point to the fact that the government values producer profit lower for income distributional or other social reasons. If, for one of these reasons, the cost of public funds exceeds unity, the case for export subsidies becomes less evident.[107] Neary has calculated that subsidies only remain optimal for surprisingly low levels of additional costs attached to public funds and this regardless whether Cournot or Bertrand competition is at work.[108]

Sixth, Dixit has demonstrated that the Brander-Spencer model also holds when it is extended to more than two firms, but only if the number of domestic firms is not too large.[109]

As a result, the case for export subsidies (or output subsidies in general) is sensitive to aspects such as the mode of competition (Bertrand or Cournot), the opportunity cost of public funds, and the number of firms, and is for that reason not considered a robust policy recommendation for governments. Nevertheless, Bagwell and Staiger have demonstrated that R&D-subsidies could be a somewhat more robust recommendation as they remain optimal

International Economics (1986), 233-249; G. M. Grossman, 'Strategic Export Promotion: A Critique', in P. Krugman (ed), *Strategic Trade Policy and the New International Economics* (Cambridge: The MIT Press, 1986), 47-68, at 58-60.

[106] J. P. Neary, 'Cost asymmetries in international subsidy game: Should governments Help Winners or Losers', 37 *Journal of International Economics* (1994), 197-218.

[107] See H. K. Gruenspecht, 'Export Subsidies for Differentiated Products', 24 *Journal of International Economics* (1988), 331-344; Neary, above n 106, at 197-218; Brander, above n 88, at 1410; J. Ma, 'Is an Export Subsidy a Robust Trade Policy Recommendation toward a Unionized Duopoly?', 20(2) *Economics & Politics* (June, 2008), 141-155.

[108] Neary, above n 106, at 197-218.

[109] A. Dixit, 'International Trade Policy for Oligopolistic Industries', 94 (supplement) *The Economic Journal* (1984), 1-16, at 11-12; see also P. A.G. van Bergeijk and D. L. Kabel, 'Strategic Trade Theories and Trade Policy', 27:6 *Journal of World Trade* (December, 1993), 175-186, at 182. The monopoly rents of each domestic firm decrease in case the number of domestic firms increases, implying that the distortion becomes less prominent relative to the terms of trade argument. Brander has indicated that the number of domestic firms relative to the number of foreign firms is important: if the number of foreign firms grows (declines) relative to the number of domestic, a subsidy (an export tax) becomes more attractive. Brander, above n 88, at 1411.

under Cournot as well as Bertrand competition.[110] Another motivation among economists in the field of strategic trade theory to focus on R&D or investment subsidies in general, is the fact that export subsidies are deemed prohibited under international agreements (e.g., EC and WTO level), whereas investment subsidies are given more leeway.[111] Hence, focusing on investment subsidies would be more relevant from a policy perspective. Investment subsidies could indeed be used as strategic trade tools given that they may indirectly have a similar profit-shifting effect as export or output subsidies: their cost-reducing effect commits the domestic firm to a higher output level, inducing an output-contracting reaction by foreign competitors. Yet, investment subsidies are only a second-best outcome as they induce firms to over-invest in the input factor in question (e.g., R&D), although causing such a distortion assumes that there are no significant positive spillovers attached to the investment in question. Section 2.3 departs from this assumption.

In light of the above-mentioned reasons, it should not come as a surprise that several 'new trade theorists' remain skeptical about the extent to which this strategic trade theory can be used as a justification for government intervention. Next to the fact that the theory is sensitive to specific assumptions, Krugman also points out that the profit-shifting rents might turn out to be small in practice[112] and that it is very difficult to gain sufficient understanding of a particular market to formulate an adequate policy given that 'each imperfectly competitive industry is imperfect in its own way'.[113] As a result, 'surprisingly few of the new trade theorists themselves are strategists', as Krugman noted.[114] Still, Brander underlines the strategic trade theory's robust general finding that an oligopoly almost always creates an incentive for intervention. At the same time, another robust finding is that such exporting countries are equally stimulated to conclude an agreement limiting such subsidization.[115]

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[110] K. Bagwell and R. W. Staiger, 'The Sensitivity of Strategic and Corrective R&D Policy in Oligopolistic Industries', 36 *Journal of International Economics* (1994), 133-150; D. Leahy and J. P. Neary, 'Robust rules for industrial policy in open economies', 10:4 *The Journal of International Trade & Economic Development* (2001), 393-409.
[111] See, for example, Leahy and Neary, above n 94, at 42-43; Leahy and Neary, above n 110, at 393-409. D. R. Collie, 'State Aid to Investment and R&D', *European Commission – Economic Papers* No. 231 (July 2005), 14 pp. Yet, this argument has to be nuanced under the WTO framework because general output or production subsidies are currently disciplined similarly as investment subsidies (see below Part II, Chapter 4, Section 4.2). Consequently, the prohibition on export subsidies does not mandate a shift in focus to investment subsidies given that output or production subsidies are disciplined similarly and are first-best options as profit-shifting instrument.
[112] Yet, Krugman acknowledges that this position is based on limited empirical evidence. He refers to a study by Dixit on the US automobile sector. A. K. Dixit, 'Optimal Trade and Industrial Policies for the US Automobile Industry', in D. B. Audretsch (ed), *Industrial Policy and Competitive Advantage* (Cheltenham: Edward Elgar, 1998), vol. 1, 175-200.
[113] P. Krugman, 'The Narrow and Broad Arguments for Free Trade', 83:2 *The American Economic Review* (1993), 362-366, at 263-264.
[114] P. Krugman, above n 113, at 263-264.
[115] Brander, above n 88, at 1447. See also below Part IV, Chapter 2, Section 2.2.

2.1.2. Countervailing duties as strategic trade instrument

Profit-shifting export subsidies by trading parties also imply that, under certain conditions, CVDs could be used as welfare improving instruments by importing countries as they would claw back some rents to domestic producers and the government as well as expand domestic production resulting from the protection of the domestic market.[116] But again, the information requirements to design these CVDs in a welfare-enhancing way might be highly demanding. Sykes therefore concludes that, 'for all practical purposes, it is impossible to determine whether a duty will enhance national welfare in a given case'.[117] Compared to the perfect market situation, such CVDs will nonetheless be less harmful in cases that more or less fit to the strategic trade situation.[118] Qiu has found that the threat of retaliation by CVDs might in theory deter export subsidization and thus make free trade optimal.[119] However, under the constraints imposed by the GATT/WTO (i.e., CVD cannot exceed the level of subsidization), the level of potential retaliation would be too low to fully deter export subsidization for profit-shifting reasons.[120,121]

[116] Dixit, above n 109, at 11-12; Sykes, above n 23, at 352; Baylis, above n 44, at 351; D. R. Collie, 'Anti-dumping and Countervailing Duties under Oligopoly: A Comment', 35:5 *European Economic Review* (July, 1991), 1185-1187. For an overview on the literature on CVDs and strategic trade policy, see World Trade Report 2009, above n 44, at 91-93.
[117] Sykes, above n 23, at 353.
[118] Sykes also refers to industries generating national R&D spillovers. Sykes, above n 47, at 707.
[119] Qiu's model assumes that (i) CVDs are imposed after the imposition of export subsidies by the foreign country (sequencing); (ii) CVDs can only be imposed if subsidization is present; and (iii) there can be a delay between subsidization and the imposition of CVDs. The first assumption, which was not included in the first models generated by Dixit (see above n 116), is also considered by Collie. Yet, Collie does not consider the latter two assumptions, even though their integration would clearly make the model more realistic. This also explains why Collie arrives at a different conclusion, namely that with a domestic CVDs response to a foreign country's tariffs, the foreign country's optimal policy to this response is usually an export *tax*. See D. R. Collie, Export Subsidies and Countervailing Tariffs, 31:3-4 *Journal of International Economics* (November, 1991), 309-324; L. D. Qiu, 'Why can't countervailing duties deter export subsidization?', 39 *Journal of International Economics* (1995), 249-272.
[120] A delay in the imposition of CVDs might also make the case of export subsidization more likely. Hartigan finds that the time-consuming demonstration of injury required under the GATT/WTO offers a first-mover advantage for the subsidizing country. Qiu, above n 119, at 249-272; J. C. Hartigan 'Perverse Consequences of the GATT: Export Subsidies and Switching Costs', 63:249 *Economica* (February, 1996), 153-161.
[121] Spencer has also shown that the maximum level of CVDs under the GATT/WTO would, under certain conditions, not deter *subsidization of capital*. Yet, only a sufficiently small subsidy would generate a positive – but by definition small – welfare effect to the subsidizing country in case it is retaliated by a maximum CVD. Hence, Spencer indicates that a credible threat to impose such maximum CVDs might likely be sufficient to deter profit-shifting subsidization of capital. B. J. Spencer, 'Capital Subsidies and Countervailing Duties in Oligopolistic Industries', 25:1/2 *Journal of International Economics* (August, 1988), 217-234.

2.1.3. Subsidies as a tool for shifting comparative advantage

Interestingly, imperfect competition also explains trade flows which cannot be explained on the basis of the law of comparative advantage.[122] Indeed, the traditional trade models (Ricardo and Heckser-Ohlin) show that countries that *differ* in relative labor productivity or factor endowment could take advantage of trade by totally *specializing* in the production of what they do relatively best (inter-industry specialization). But these traditional models failed to explain two important aspects of international trade flows: *why* do countries with similar labor productivity (technology) or factor endowment trade and *why* do countries often import as well export similar products (intra-industry trade). The 'new' trade theory (1970s-1980s) explained these trade flows on the basis of internal or external economies of scale at the producer's side and 'love of variety' at the consumer's side.[123]

In Krugman's classical 'monopolistic competition model', trade increases market size and thus gives firms (or the industry[124]) the opportunity to produce at a larger scale. At the same time, a single firm (or industry) supplying the total market does not emerge as consumers prefer to choose between different varieties of a single product ('love of variety'). The benefits of trade are threefold: it enables firms (or industries) to exploit their internal (or external) economies scale and thus to produce at lower average costs and consumers to enjoy not only a larger variety of products but also at a lower price.[125] Small firms (or industries) unable to benefit from market opening will go out of business but the location of the remaining 'grown up' firms (or industries) is much more arbitrary and unpredictable than under the traditional trade model.[126]

Now, does it matter if foreign countries target markets in which internal or external economies of scale play an important role?[127] As will be explored below, it does indeed

[122] See above Chapter 1, Section 1.4.

[123] In case of *internal* economies of scale (e.g., large fixed costs), the cost per unit diminishes if the size of an individual *firm* enlarges, whereas under *external* economies of scale, the cost per unit does not depend on the size of firm but on the size of the *industry*. So-called 'Marshallian externalities' (e.g., local knowledge spillovers) explain why such external economies of scale could be present (see below n 185).

[124] Krugman's model relates to *internal* economies of scale but Eaton extends it to the presence of *external* economies of scale. J. Eaton, 'Credit Policy and International Competition', in P. Krugman (ed), *Strategic Trade Policy and the New International Economics* (Cambridge: The MIT Press, 1986), 115-145, at 125-126.

[125] WTO Secretariat, *World Trade Report 2008 – Trade in a Globalizing World* (Geneva: WTO Publications, 2008), 178 pp., at 46.

[126] If trade costs are substantial, firms in sectors enjoying economies of scale would settle in countries having a large domestic market ('home market effect'). In the monopolistic competition, two-country model, each country will produce different varieties of the same product (intra-industry trade). Each country will produce fewer varieties than under autarky (which enables them to benefit from economies of scale) but more varieties (domestically produced plus imported) will be available to consumers.

[127] While the monopolistic competition model is useful to explain why countries with similar technology or factor endowment would still trade and benefit from it, the most common form of market structure in case of internal economies of scale are oligopolies, in which only a few firms compete. Krugman and Obstfeld, above n 104, at 131.

matter in case of external economies of scale (below Section 2.3). Equally, as this section has demonstrated, it also matters in case of *internal* economies of scale resulting in a market form (e.g., oligopoly or monopoly) where firms generate true economic profits (price is above average costs) even if trade is opened.[128] Recalling the example attributed to Lincoln, the US would not only have the production of the good in question but also something extra, namely 'money', which should be better understood as true 'economic profit' or excess returns.[129] So, it is in the US interest to keep or capture such excess returns. Importantly, it may use its trade policy to this end. As this section has shown, governments could give their firms a strategic advantage in oligopolistic markets by offering output subsidies (profit-shifting) and, under certain conditions, CVDs could be an effective response by other countries. In markets where firms have occupied a monopoly position, governments could by subsidization and/or CVDs deter foreign firms from entering this profitable market. CVDs might indeed be employed to deter entrance in monopolies or, alternatively, to respond to foreign predatory pricing fuelled by subsidies which aims at monopolizing the market.[130]

An example still topical today is the entrance of Airbus in the 1980s in the market for intermediate-range commercial jets, at the time dominated by US firms Boeing and McDonnell-Douglas. This entrance was realized by protection in the EC market and government subsidization, which were deemed required to cover the high sunk costs of the project.[131] The EC clearly had an interest in entering this market in which true 'economic profits' could be reaped (and local knowledge spillovers could be generated) but the world as a whole would also benefit from increased competition in this market.[132,133] On the other hand, the US had an interest in deterring entrance of Airbus in this market and therefore considered the EC protection and subsidies as unfair practices mandating countermeasures

[128] In monopolistic competition models, all economic profits are assumed to be competed away in the long run.
[129] Dixit, above n 6, at 289.
[130] Obviously, world welfare is reduced in the first case, whereas it would improve in the second case. In case of predatory pricing, CVDs are second-best because anti-trust law would be optimal. But there is very little evidence that predatory pricing supported by governments is undertaken. Sykes, above n 23, at 344-354; World Trade Report 2009, above n 44, at 91; Jackson, above n 57, at 744.
[131] This is in fact parallel to the traditional infant industry argument (see below). A. K. Dixit and A. S. Kyle, 'The Use of Protection and Subsidies for Entry Promotion and Deterrence' 75:1 *The American Economic Review* (March, 1985), 139-152; W. H. Branson and A. K. Klevorick, 'Strategic Behavior and Trade Policy', P. Krugman (ed), *Strategic Trade Policy and the New International Economics* (Cambridge: The MIT Press, 1986), 241-255, at 244-246; B. J. Spencer, 'What Should Trade Policy Target?', in P. Krugman (ed), *Strategic Trade Policy and the New International Economics* (Cambridge: The MIT Press, 1986), 69-89, at 84-85.
[132] This is the case unless entrance would induce firms to produce at an inefficient scale.
[133] It has been estimated that the entrance of Airbus has reduced average price for commercial aircrafts by 3.5 per cent. See World Trade Report 2006, above n 9, at 88.

(e.g., CVDs).[134] The Airbus – Boeing rivalry finally resulted in mutual claims by the US and EC before the WTO.

2.2. LABOR MARKET IMPERFECTIONS

As explained above, no case for either subsidizing or CVDs can be constructed under perfect market assumptions.[135] Such a model also assumes that labor markets function perfectly, indicating that wages in any particular sector are competitive: they equate marginal product and do not exceed the returns available elsewhere (opportunity cost) to marginal workers.[136] These workers are therefore indifferent between their current job and the next best alternative, implying the absence of involuntary unemployment.[137] Hence, there is no reason to offer wage subsidies or any other type of subsidies (e.g., production subsidies) to boost labor in a particular industry. If a country is confronted with subsidized imports, CVDs to protect employment in the affected industry are also not an optimal instrument as the benefits of subsidized imports to consumers are larger than the loss to producers (capital and labor inputs).[138] Workers in the affected industry are indeed always worse off. They will have to accept lower wages if they are unwilling or unable to move or, in case they move to other sectors, they will have to accept lower wages insofar their previous earnings were based on industry-specific skills.[139] In theory, however, the net welfare gain allows governments to directly compensate those inputs negatively affected and still benefit overall.[140]

Yet, the competitive labor market assumption might not always hold. Two paragraphs illustrate this issue through an analysis of somewhat prototypical situations occurring in developed and developing countries respectively. Both analyses have in common that government intervention might be warranted in case wages in some sectors are higher than the opportunity cost of labor because of a market failure. The final part of this section looks at how the case for subsidization and/or CVDs might change if adjustment costs, such as (temporary) involuntary unemployment, are taken on board in the model.

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[134] Entrance could only be blocked by imposing CVDs if, in addition to protection and subsidization, entrance to the US market was needed for Airbus to cover its sunk costs. Boeing mainly complained about the subsidies and less about protection. Krugman, above n 60, at 116.

[135] Such a model also assumes that the labor market functions perfectly, implying that wages (marginal cost of labor) equal their marginal product in the labor market equilibrium.

[136] Sykes, above n 23, at 336.

[137] Unemployed workers searching for jobs only do so by choice. A. O. Sykes, 'Protectionism as a "Safeguard": A Positive Analysis of the GATT "Escape Clause" with Normative Speculations', 58:1 *The University of Chicago Law Review* (Winter, 1991), 255-305, at 266.

[138] This assumes that the country is a net-importer of the subsidized good.

[139] Krugman, above n 60, at 90.

[140] Thus, this also assumes that the taxes levied to channel welfare from consumers to producers do not in turn create new distortions.

2.2.1. Labor market failures in developed countries

In developed countries, institutional factors such as labor unions might have the result that wages (marginal cost of labor) in those unionized sectors are higher than the returns available in the next best employment alternative to marginal workers.[141] Workers in those sectors thus receive a wage premium or 'rent' above the competitive wage paid elsewhere.[142] As a consequence, a domestic market failure in the labor market occurs: too little employment in the industry's labor market equilibrium results in a price above and output below the perfect market equilibrium level. Government intervention thus seems warranted but the first-best option of simply neutralizing the wage premium might be politically unacceptable because of the strong position of labor unions. Recalling the theory of the second-best, a wage subsidy or production subsidy could be suggested as respectively second- and third-best responses as these would boost employment and output in the unionized sectors. But, as Krugman as well as Sykes have indicated, these options might as well be politically unacceptable (as it would subsidize an already unionized sector) and hard to calculate.[143] These authors have demonstrated that, under those circumstances, CVDs might become appropriate as a second-best (or maybe better labeled as 'fourth-best') response in case foreign subsidization pushes down price and employment in unionized sectors.[144] If the premium wage remains intact (domestic distortion is unaffected), domestic output would indeed be reduced even further as a result of subsidized imports. In the presence of such distortion, subsidized imports are not *per se* welfare improving for net-importing countries any more because part of the loss to producers (i.e., the wage premium multiplied by the unemployment) is certainly not translated into a benefit to domestic consumers but is instead captured by foreign subsidized producers.[145] Depending on whether the total loss to producers would not be compensated by a benefit to consumers, CVDs could thus be a welfare-improving though second-best instrument.[146] On the other hand, if the depressed price induces a reduction or even elimination of the domestic distortion (i.e., workers accept a wage comparable to the opportunity cost), employment and domestic output would expand at the lower price caused by foreign subsidization. Framed otherwise, if foreign subsidization induces the country in

[141] Sykes also refers to minimum wages. Sykes, above n 23, at 336.
[142] The wage in those sectors is above the opportunity cost of labor: marginal workers earn a premium over the returns available in the next best employment alternative.
[143] Krugman, above n 60, at 337.
[144] The same response applies if the lower price is not the result of a foreign subsidy but, for example, a consequence of foreign industries' higher productivity. In those cases, a tariff could become appropriate as second-best response.
[145] The crux of the argument is that the foreign subsidized industry takes advantage of the domestic distortion reflected in a higher price and output compared to the equilibrium level without domestic distortion.
[146] For example, this would be the case if the price decline would be small or demand inelastic.

question to reduce or eliminate the distortion, it will more likely become welfare enhancing.[147]

2.2.2. Labor market failures in developing countries

A specific feature of many developing countries' labor markets is that they present a surplus of labor supply, resulting in low wages and high levels of 'self-employment'. In Lewis' classical model, agricultural labor was so abundant that its marginal product was close to zero. Put otherwise, if a worker would leave the farming sector to work in an export industry, the agricultural output would not be reduced (marginal product is zero) and society would gain by any value added to the manufacturing sector.[148] Yet, the 2008 Growth Report drafted by the Commission on Growth and Development observed that the exporter in the manufacturing sector, which operates in the formal labor market, cannot distract such surplus labor by simply paying one cent but that it has to pay more.[149] As a result, wages in the exporting sector are greater than the opportunity cost of labor (which is close to zero). Hence, the social benefits of employment in the exporting sector are higher than their private returns until surplus labor is absorbed and wages converge to the opportunity cost in the agriculture sector. According to the Growth Report, this would justify industrial policies supporting the exporting industry so that the private returns become closer to their social benefits. As a pragmatic and temporarily solution, the Report proposes to allow export-oriented firms to recruit workers on easier terms (e.g., in special economic zones) than those prevailing in the formal sector, without however curtailing minimum labor rights.[150,151]

[147] The more the domestic distortion is reduced, the higher the likelihood that foreign subsidized competition is welfare enhancing.

[148] Ray explains why workers in the informal sector (e.g., agriculture) are employed even beyond the point where the marginal product equals the 'wage'. In self-employed farming, the income of all family members is added and their 'wage' simply reflects the average output (income sharing). Ray, above n 72, at 357.

[149] The Growth Report does not clearly mention which type of market failure precludes the exporting sector from distracting surplus labor by only paying one cent. It seems that the market failure is related to the strict division between a formal sector, in which exporters operate, and an informal sector. Higher wages and terms in the *formal* economy are fenced off by regulations or labor agreements, which prevent outsiders from bidding down the wages of insiders. In the words of the Growth Report: 'In a surplus-labor economy, they are playing something close to a zero-sum game: there are only so many well-paid, tightly regulated jobs to go round. If you gain, I lose'. As elaborated in the full text, the Growth Report's solution is not to dismantle the formal economy but to create a limited exception for export-oriented firms. Commission on Growth and Development, *The Growth Report – Strategies for Sustained Growth and Inclusive Development* (Washington DC: The World Bank, 2008), 190 pp., at 45-48.

[150] The Report points to China's successful strategy which did not require the emerging exporting sector to offer the same wages or terms than the wages/terms provided by state-owned companies.

[151] In fact, the Report does not explain why exporters should be treated any different from other manufacturers operating in the formal economy with regard to this argument related to the labor market.

2.2.3. Government intervention to ease adjustment costs

The perfect market assumption does not take into account that workers in the import-competing industry not only face a reduction in their wage (which is more than compensated by a benefit to consumers in net-importing countries) but that they also bear short-term adjustment costs as it takes time (temporary unemployment) and investments (e.g., retraining) to find a new job in another sector.[152] Temporary unemployment presents such an adjustment cost to a country as it at minimum loses the value added by those workers during this search period.[153] Here, government intervention might be warranted to facilitate this adjustment process.[154] First, offering subsidized credit to the import-competing industry so as to give it some 'breathing space' to become competitive again (or simply to remain operational in case of temporary foreign subsidization) and thus to avoid such adjustment costs for workers, might be justified. Yet, this is only a second-best response as it assumes that the private capital market does not function perfectly (i.e., unwilling to bridge this phase).[155] Second, government intervention in the form of subsidization or 'contingent' protection (e.g., safeguards, CVDs) might also be useful to slow down the adjustment process in the import competing industry in case of congestion in the labor market.[156] Such congestion might, for example, be present when the targeted industry is a major employer in the economy. The more workers are unemployed at the same time, the less likely that they will find a job. Hence, by *temporarily* protecting jobs in the import-competing industry, the chances for unemployed workers to find a job increases (congestion is reduced). Such benefits of contingent protection (e.g., CVDs) or subsidization should be included into the calculation of their welfare effect.[157] This argument somewhat corresponds to Lawrence's observation back in the 1980s that foreign targeting of US industries in the short run could lead to 'the exporting of unemployment' in case there is great excess capacity in an industry (e.g., steel) during periods of generally high unemployment.[158] Whereas the US benefited from cheaper imports of steel, it also had to pay for the costs of unemployment and other trade adjustment assistance. Under those kinds of circumstances, subsidizing steel becomes a beggar-thy-

[152] Similarly, there might be adjustment costs related to the reallocation of capital.
[153] Equally, other types of adjustment costs exist (e.g., retraining costs). M. Bacchetta and M. Jansen, 'Adjusting to trade liberalization – The role of policy, institutions and WTO disciplines', *WTO Publications Special Studies 7* (Geneva: WTO, April 2003), 69 pp., at 15.
[154] World Trade Report 2006, above n 9, at 97-98; World Trade Report 2009, above n 44, at 27.
[155] It also assumes that the government is able to pick those industries that would become competitive again. Trade protection in the form of CVDs or safeguards would only be a third-best response as they hurt domestic consumers. Sykes, above n 137, at 264; World Trade Report 2006, above n 9, at 97.
[156] The models include the assumption of 'congestion externalities', which means that if workers search for a job in the exporting sector they make it harder for other searchers in that sector to find a job. Hence, as the pool of searchers grows, the probability for finding a job falls.
[157] However, safeguards might be more appropriate than CVDs as they restrict importation from all importing countries. See also Sykes, above n 23, at 343-344.
[158] See R. Z. Lawrence, comment on Krugman in P. Krugman, 'The US Response to Foreign Industrial Targeting', 1984:1 *Brookings Papers on Economic Activity* (1984), 77-131, at 126-127.

neighbor policy: it might make the subsidizing country better off but only at the expense of trading partners. According to Lawrence, the imposition of CVDs could therefore be an adequate response by trading partners. As will be discussed in Section 2.5, this argument is highly relevant in the current situation of an economic downturn (e.g., automobile bailouts).

2.3. INDUSTRIAL POLICY IN DEVELOPED COUNTRIES: THE ROLE OF SUBSIDIES FOR SPURRING RESEARCH AND DEVELOPMENT

Knowledge spillovers occur when knowledge generated by one firm could be captured by other firms in the same industry (intra-industry spillover) or in other industries (inter-industry spillover) without adequate compensation.[159] As a result, firms under-invest in R&D as part of the benefits of their investment, namely its 'marginal external benefit', spillovers to other firms without return (non-excludable). Put differently, the social return of investment in knowledge is higher than the private return. As noticed above, governments should target market failures as precisely as possible to prevent distortions elsewhere in the economy (targeting principle).

Now, how should a government correct the market failure in which firms cannot appropriate the knowledge generated by R&D investments? The benefits of the investment could be appropriated by the investing firms if adequate intellectual property rights are put in place but, in practice, these seem to offer only limited protection to innovations.[160] Alternatively, governments could stimulate R&D investment by subsidization.[161] But how should such a R&D subsidy look like? Subsidizing technology intensive industries (e.g., production subsidy) might not be sufficiently fine-tuned as it would not directly target R&D investment.[162] Instead, governments could subsidize R&D investment directly and independently of the sector where it takes place but, in turn, this might be difficult to

[159] Knowledge, which has public good characteristics, is defined broadly by economists as 'any trick, technique, or insight that allows an economy to generate more out of its existing resources of land, labor, and capital'. Commission on Growth and Development, above n 149, at 41.

[160] Krugman and Obstfeld, above n 104, at 277; E. Helpman, *The Mystery of Economic Growth* (Cambridge: The Belknap Press of Harvard University Press, 2004), 203 pp., at 44. Intellectual property rights also do not remedy other types of market failures linked to R&D investments, such as economies of scale. The high fixed costs often associated with R&D investments imply an increase of economies of scale, whereby the initial R&D-cost might never be fully recovered by the private investor. Nonetheless, such investment might be justified on the basis of the gains to consumers (see also below n 209). World Trade Report 2006, above n 9, at 83; Grossman, above n 66, at 97-98.

[161] By subsidizing investment, the marginal private benefit of investment increases, optimally up to the level that equals the marginal social benefit. If firms would cooperate in setting R&D investment levels, the positive spillovers would in theory become internal and as a consequence, no government intervention would be needed. D. Leahy and J. P. Neary, 'R&D spillovers and the case for industrial policy in an open economy', 51 *Oxford Economic Papers* (1999), 40-59, at 47- 48. Rodrik indicates that R&D subsidies are the first-best option, whereas patent protection is only second-best. D. Rodrik, *One Economics – Many Recipes – Globalization, Institutions, and Economic Growth* (Princeton: Princeton University Press, 2007), 255 pp., at 106, footnote 106.

[162] See, for example, Grossman, above n 66, at 108-109.

implement, for example due to the difficulty to define 'R&D investment'.[163] Whereas a broad interpretation of R&D-investment might cause misuse, a strict definition risks favoring formal and traditional forms of research units over the informal set-ups which are known to be more innovative.[164] Furthermore, because governments maximize their *national* welfare, they are only interested in internalizing 'national spillovers', which benefit other domestic firms. In contrast, they have no incentive to subsidize investments that merely have spillovers to foreign firms, even though world welfare would rise if investments having such 'international spillovers' are also subsidized. So, the lower the level of spillovers flowing abroad, the more likely domestic firms' investments will be subsidized.[165] This analysis holds for subsidies to R&D investments in competitive or monopolistic competitive markets where firms do not behave strategically and profits are zero.[166]

The picture is somewhat more complicated in case of R&D subsidies to firms operating in oligopolistic markets.[167] If no significant positive spillovers on the profits of competitors are present, investment levels can be considered as 'unfriendly' (lowering competitors' profit in total)[168] and as strategic substitutes (lowering competitors' profit in the margin).[169] If R&D does not have positive spillover effects but is used as a strategic tool between competitors, governments would better tax R&D investment to undo the distortion caused by over-investment in R&D for strategic reasons and, at the same time, offer export subsidies to channel foreign profits to domestic firms. If export or other output subsidies would be unavailable, R&D subsidies could be a second-best instrument for capturing foreign profit.[170] The effect on world welfare is unclear. As a strategic tool, the investment subsidy boosts overall output, hereby reducing the oligopolistic distortion. At the same time however, it creates a new distortion in the input market. Accordingly, introducing a prohibition on export

[163] Malony and Rodriguez-Clare hold that focusing on high R&D sectors might be relevant if targeting R&D directly is not advisable for practical reasons. W. Maloney and A. Rodríguez-Clare, 'Innovation Shortfalls', 11:4 *Review of Development* Economics (2007), 665–684, at 669.
[164] Krugman and Obstfeld, above n 104, at 278.
[165] B. J. Spencer, 'What Should Trade Policy Target?', in P. Krugman (ed), *Strategic Trade Policy and the New International Economics* (Cambridge: The MIT Press, 1986), 69-89, at 78-79; Maloney and Rodríguez-Clare, above n 163, at 669.
[166] In case of monopolistic competition, this at least holds true in the long run.
[167] Leahy and Neary, above n 94, at 41-66; Collie, above n 111; Krugman, above n 60, at 109.
[168] The cost reducing effect of investment subsidies leads to in an increase of domestic output, resulting in lower foreign output levels and thus lower foreign profit.
[169] If investment levels are strategic substitutes, an increase in the domestic firm's investment level leads to a lower optimal level of investment for competitors. The marginal profitability of competitors' investment lowers because an increase in the domestic firm's investment level reduces their output (non-strategic element) as well as their return from pushing the domestic firm down its output reaction function (strategic element). Leahy and Neary, above n 110, at 400 and 405.
[170] By increasing home investment, foreign investment is reduced (because of strategic substitutability) which in turn raises home profits (because of unfriendliness). Leahy and Neary, above n 110, at 405-406.

or output subsidies and allowing R&D subsidies is sub-optimal for world welfare if R&D investments in oligopolistic markets do not generate significant spillovers.

In contrast, if investment levels generate high positive spillovers on the profit of competitors, they are considered as 'friendly' and as 'strategic complements'.[171] In this case, spillovers not only increase competitors' profits but also boost their incentive to invest more in R&D. Two types of spillovers could be present. First, if R&D does have spillover effects but only on domestic firms, the optimal intervention depends on whether R&D is used as a strategic tool next to output levels.[172] If R&D is not used as a strategic tool, domestic firms under-invest in R&D because they do not internalize the positive spillover effects on other firms. Thus, a welfare optimizing government would provide a R&D subsidy to internalize the externality, combined again with an export subsidy which generates the profit-shifting effect. Yet, if R&D is used as a strategic tool, the optimal policy is unclear given that the government should at the same time tax R&D to correct strategic over-investment in R&D together with subsidization of output/export and equally subsidize R&D to internalize the externality. Hence, if R&D is used as a strategic tool, domestic spillovers make subsidization a more probable option than under the situation where no spillovers are present.[173] Second, if R&D generates positive intra-industry international spillovers (i.e., to foreign competitors), the policy recommendation depends on whether the spillovers are high.[174] From the perspective of profit-shifting, governments would better tax R&D to induce lower R&D and thus lower foreign output.[175] However, contracted foreign R&D implies reduced 'spillback' effects to domestic firms, which in turn result from foreign R&D investment. In this respect, the fact that R&D subsidies benefit foreign firms is an argument in favor of subsidization because of this spillback effect: higher domestic R&D has a positive spillover effect on foreign R&D, which, in turn, has a positive 'spillback' effect on domestic R&D. The rent-shifting effect thus works towards a tax, whereas the spillback effect works towards a subsidy. If the spillover is sufficiently high, the national government would offer a subsidy.[176] Tempered by the negative rent-shifting effect, however, governments still under-subsidize from the perspective of world welfare when high international spillovers are present.[177] Indeed, if

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[171] They lower competitors' cost and thus increase their profit in total and at the margin. They become friendly if the spillover effect is high enough to offset the strategic effect. Leahy and Neary, above n 94, at 41-66.

[172] There is no strategic relationship between domestic firms. If spillovers are purely domestic, R&D investments are thus still unfriendly and strategic substitutes vis-à-vis foreign competitors.

[173] Leahy and Neary, above n 161, at 44-49.

[174] Recall that output levels are unfriendly and strategic substitutes under Cournot competition.

[175] Thus, R&D is also used as a strategic tool.

[176] If R&D is used as a strategic tool, firms strategically under-invest in R&D in case high spillovers are present. The optimal subsidy would be higher than under the situation when R&D is not used as strategic tool to correct for this additional under-investment in R&D. Leahy and Neary, above n 161, at 50.

[177] Leahy and Neary, above n 161, at 49-53; Leahy and Neary, above n 94, at 41-66.

countries would cooperate in tackling international spillovers, the incentive to tax R&D for strategic reasons would disappear and they would subsidize up to the point where the international spillover is fully internalized. The case for subsidization would even be stronger if the beneficial effect of the subsidy to consumers is taken into account.

It is generally acknowledged that R&D investments indeed generate persistent and widespread positive spillovers.[178] Broadly speaking, subsidizing such R&D investment seems therefore justified as an industrial policy instrument in competitive as well as imperfectly competitive markets, and national governments will be more willing to offer such subsidies if spillovers remain local.[179] The 'new' or endogenous growth theory exactly points to these positive knowledge spillovers as engines of economic growth as they foster productivity.[180] By investing in R&D, firms aim at gaining market power flowing from the invention of higher-quality products ('vertical innovations') or totally new products ('horizontal innovations').[181] In this way, firms generate private knowledge but equally contribute to the aggregate stock of public knowledge and thus do not grasp all the benefits of their investment.[182] While such knowledge could spillover to other sectors ('inter-industry'), the strongest spillovers take place between industries in the same sector ('intra-industry'), particularly in those sectors that are knowledge-intensive.[183] Moreover, spillovers are

[178] For example, see D. Audretsch and M. Feldman, 'Knowledge Spillovers and the Geography of Innovation', in V. Henderson and J. F. Thisse (eds), *Handbook of Urban and Regional Economics*, vol 4, (Amsterdam: North Holland, 2004), 2713-2739; Leahy and Neary, above n 161, at 50; Helpman, above n 160, at 42; Grossman, above n 66, at 106-108.

[179] Alternatively, R&D subsidies are considered legitimate because the scale, uncertainty, and long-term horizon of R&D investments often make private capital sector funding unavailable. In this case, an R&D subsidy is only a second-best solution as the first-best policy would be to tackle the capital market failure directly. D. B. Audretsch, 'An Evaluation of Japanese R&D and Industrial Policies', in D. B. Audretsch (ed), *Industrial Policy and Competitive Advantage* (Cheltenham: Edward Elgar, 1998), vol. 1, 315-343, at 332.

[180] Technological change is no longer determined 'exogenously' as under the neoclassical growth model (Solow model) but results from investment decisions by firms which can be stimulated by government interventions. Such technological change spurs total factor productivity (i.e., the amount of output that can be produced with a given amount of inputs). Further, by making investment more profitable, this increase in total factor productivity also induces capital accumulation, which is a second and indirect channel of growth creation. Helpman, above n 160, at 84.

[181] Innovation could be defined broadly as 'all the activities that increase the knowledge available to a firm so that it can produce more or better goods at lower cost'. A. Rodríguez-Clare, *Microeconomic Interventions After the Washington Consensus* (Washington: Inter-American Development Bank, February 2005), 37 pp., at 14; World Trade Report 2008, above n 125, at 65-66.

[182] This externality explains why aggregate increasing returns to scale with a rising marginal productivity of public knowledge (permitting continuing growth) and a declining marginal productivity of private knowledge (permitting firms to behave competitive as price takers) can coexist. As a result, economies of scale (aggregate level) and competitive markets (firms as price takers) can exist simultaneously. Helpman, above n 160, at 38.

[183] Rodríguez-Clare, above n 181, at 14, 18 and 22; Maloney and Rodríguez-Clare, above n 163, at 669-672.

attenuated by geographical distance because of the tacit nature of knowledge.[184] Hence, local knowledge spillovers are important factors explaining the emergence of a 'cluster', which is 'a group of related industries and agents located in the same region or country' (e.g., Silicon Valley). Because of such local knowledge spillovers or other so-called 'Marshallian externalities', firms benefit from geographical concentration (agglomeration effects) and their productivity thus depends on the size of the cluster to which they belong (*external* economies of scale).[185] As the 'new trade theory' explained (see above), trade enables countries to reap these external economies of scale and the world as a whole benefits from concentrating such industries in certain locations as a higher level of productivity is reached. Yet, countries benefit more from trade if those industries are located in their territory.[186] Importantly, Norman and Venables have demonstrated that world welfare is maximized when countries can unrestrictedly compete for attracting such clusters by offering subsidies.[187] On the other hand, international disciplines restricting such subsidization would be world welfare depressing as it would result in too many clusters, each operating at an inefficient low scale.[188]

Consequently, the 'new trade theory' highlighted the presence of external economies of scale as a second circumstance legitimizing a country's active trade policy, next to securing profits in oligopolistic or monopolistic markets (excess returns).[189] In terms of the Lincoln-example elaborated above, producing computers would generate something extra, namely positive knowledge spillovers to other firms in the same or related industries (or the wider economy),

[184] Rodríguez-Clare, above n 181, at 14, 22; A. Rodríguez-Clare, 'Coordination Failures, Clusters, and Microeconomic Interventions', *Economia* (Fall, 2005), 1-42, at 18; Audretsch and Feldman, above n 178, at 2713-2739.

[185] Rodríguez-Clare, above n 184, at 9. Clusters emerge in the presence of externalities that are industry-specific and local ('Marshallian externalities'), implying that firms benefit from production and innovation of *neighbouring* firms in the same and related industries. Marshall identified three types of benefits: knowledge spillovers, input sharing, and labor market pooling. The World Trade Report 2008 also points to the importance of knowledge spillovers in explaining geographical concentration. World Trade Report 2008, above n 125, at 92.

[186] P. Krugman and A. J. Venables, 'Globalization and the Inequality of Nations', 110:4 *The Quarterly Journal of Economics* (November, 1995), 857-880; V. D. Norman and A. J. Venables, 'Industrial Clusters: Equilibrium, Welfare and Policy', 71 *Economica* (2004), 543–558. Such external economies of scale can also imply that countries are 'locked in' in wrong areas of specialization and therefore justify infant industry protection.

[187] The model's intuition is that competition for clusters will decrease the price and increase the output level of the sector, which through the terms of trade will also benefit importing countries not having reaped the cluster and thus reduce their incentive to subsidize in order to attract the cluster. The Norman and Venables standard model assumes that individual countries cannot affect the terms of trade (small country assumption). In case of large countries, the negative terms of trade effect resulting from subsidization will lead countries to subsidize too little. Norman and Venables, above n 186, at 543–558.

[188] The limitation on subsidies has the effect of both reducing the size of clusters and increasing their number as it induces more countries to offer subsidies so as to attract clusters. Norman and Venables, above n 186, at 551-552.

[189] As elaborated below, such local knowledge spillovers also underpin the infant industry argument. See P. R. Krugman, 'Introduction: New Thinking about Trade Policy', in P. Krugman (ed), *Strategic Trade Policy and the New International Economics* (Cambridge: The MIT Press, 1986), 1-22, at 10-14.

and countries would therefore benefit from producing such computers locally.[190,191] If foreign targeting leads a country to invest less in sectors generating such spillovers (i.e., social return is higher than the private return), technological innovation and growth would slow down. Importantly, this argument thus hinges on the assumption that spillovers are present and that they are national instead of international in nature. Indeed, if such spillovers are international, industries abroad would equally benefit from technological progress generated in the computer sector.[192]

The classical example on potential *external* economies is the fierce rivalry for the semiconductor industry that started in the 1970s and is still ongoing today.[193] Combining protection and promotion, Japan started targeting the semiconductor market dominated by the US and already led production of one type of semiconductors, namely Random Access Memories (RAM), in the mid-1980s. The US' concern was that this lead in RAM production would be used as a springboard to dominate the whole semiconductor industry (and other industries making use of semiconductors) because of strong local technological spillovers as well as excess returns attached to it.[194] Since the 1990s, however, it became clear that these effects did in fact not materialize given that the US still dominated leading-edge segments of the market and other Asian countries (e.g., Taiwan, South-Korea and China) started targeting and entering the semi-conductor industry, pushing down the price.[195] By the end of the 1990s, RAM production had become much like a commodity as many firms could produce it and no strategic benefits seemed to be involved.[196] Hence, Krugman and Obstfeld conclude that this

[190] The profit-securing argument in oligopolistic markets or monopolies relates to the exceptionally high returns generated by capital and labor in those sectors. In contrast, the externality argument relates to higher returns generated by a sector to capital and labor employed elsewhere in the economy. Eaton indicates that this would be a reason for subsidizing exports from industries generating significant economies of scale as the latter improves the chances that the country would specialize in those industries, although the external economies of scale rather call for a production subsidy. Kurgman, above n 189, at 13; Eaton, above n 124, at 118-120.

[191] In theory, if spillovers remain purely intra-industry, other countries could still benefit through their effect on the terms of trade.

[192] If innovations do not generate spillovers but are fully appropriable by the innovator (e.g., patent protection), no case for R&D subsidies can be made. It could in principle raise a strategic trade policy argument in case such industries generate true economic profits. If such industries have the characteristics of an oligopoly, firms might even invest too much in R&D (see above). See Krugman, above n 60, at 109.

[193] M. Borrus, L. D'Andrea Tyson, and J. Zysman, 'Creating Advantage: How Government Policies Shape International Trade in the Semiconductor Industry', in P. Krugman (ed), *Strategic Trade Policy and the New International Economics* (Cambridge: The MIT Press, 1986), 91-114.

[194] The US believed that the excess returns in the RAM segment were needed to finance innovation in other products. Krugman, above n 60, at 113.

[195] In the 1980s already, Krugman expressed doubts that such external economies were important in the RAM segment but equally did not foreclose the possibility that the success of such programmes had contributed to Japan's high-technology growth. Krugman, above n 60, at 111-112, 119-121.

[196] The chipmarket is also compared with commodity markets as both have a tendency to oversupply the market and as this oversupply is fuelled by government support. See'The Semi-Conductor Industry: Under New Management', *The Economist* (2 April, 2009).

textbook example turned out as 'a lesson in the pitfalls of activist trade policy'.[197] In conclusion, the presence of knowledge spillovers therefore not only justifies government support but might also warrant government intervention in order to capture or keep industries generating such spillovers (e.g., knowledge intensive industries) *if* these spillovers are indeed predominantly local in nature. Yet, targeting high-tech sectors might be a risky trade policy for two reasons, namely the information requirements for detecting and calculating such spillovers, which 'by definition leave no trace in market transactions'[198], and subsidization by other countries, which depresses the terms of trade. The more R&D spillovers become international in nature, the lesser governments are inclined to offer subsidies in order to keep the sector in question or spur R&D levels and, from the perspective of other countries, the less important it becomes to target the sector in question. However, the world as a whole would still benefit if such investments are stimulated by R&D subsidies.

Given that developed countries have their comparative advantage in industries generating most spillovers (knowledge-intensive industries), they should invest more in R&D.[199] Unsurprisingly, the overwhelming majority of R&D investments are indeed made in industrialized countries.[200,201] From the perspective of knowledge-lagging developing countries, this raises the important question on whether some of the generated stock of knowledge could nonetheless spill over and thus boost the productivity of their domestic firms.[202] Important channels of such knowledge spillovers across the board could be

[197] Krugman and Obstfeld, above n 104, at 282; Krugman, above n 64, at 23-24. The Economist foresees that the semiconductor market will become largely concentrated in Asian countries, but excess returns will be minimal, partly because these Asian countries will sustain support for their national 'champions'. See 'The Semi-Conductor Industry: Under New Management', *The Economist* (2 April, 2009).

[198] R. E. Baldwin and P. R. Krugman, 'Market Access and International Competition: A Simulation of 16K Random Access Memories', in D. B. Audretsch (ed), *Industrial Policy and Competitive Advantage – Volume 1* (Cheltenham: Edward Elgar, 1998), 22-48, at 171.

[199] The higher level of R&D- spending in OECD countries might be explained and justified on the basis of their comparative advantage in knowledge-intensive industries. Developing countries should not invest in R&D up to the level of knowledge-intensive countries as their level of R&D spending might just reflect their different specialization pattern (i.e., their comparative advantage). See also below n 328. Maloney and Rodríguez-Clare, above n 163, at 665–684.

[200] Helpman held in 2004 that 95% of R&D investments are made in industrialized countries and Keller specified in 2002 that Germany, the US, and Japan together accounted for more than 75% of R&D spending. On the basis of UNESCO data, Brahmbhatt and Hu also found that almost 80% of R&D investments are made by developed countries. M. Brahmbhatt and A. Hu, 'Ideas and Innovation in East Asia', *The World Bank - Policy Research Working Paper* No. 4403 (November, 2007), 48 pp., at 18; Helpman, above n 160, at 64; W. Keller, 'Geographic Localization of International Technology Diffusion', 92:1 *The American Economic Review* (March, 2002), 120-142, at 120; World Trade Report 2006, above n 9, at 83.

[201] Moreover, most innovations are made in a small number of developed countries. World Trade Report 2008, above n 125, at 70.

[202] Again, this should not mean that a foreign country *ipso facto* loses from R&D investments generating merely domestic spillovers given that this foreign country could benefit from a positive terms of trade effect if both countries trade (see below Part I, Chapter 2, Section 2.4.3).

international trade (attached to imports as well as exports) and foreign direct investment.[203] Given that such knowledge is more easily adapted to local circumstances by domestic firms that invest in R&D and in the case sufficient human capital is in place, knowledge-lagging developing countries are advised to not merely to open these channels but to improve their capacity to absorb such innovations ('absorptive capacity') as well.[204] As will be analyzed in-depth in the following section, this potential dynamic benefit of both trade and foreign direct investment (FDI) could be an argument for developing countries to follow an export promotion strategy and to offer incentives so as to attract FDI.

2.4. Industrial policy in developing countries: The role of subsidies for spurring economic growth

2.4.1. Development strategies: Import-substitution and export-promoting strategies

Ideas on the proper role of the government in the allocation of resources in developing countries have evolved over the last decennia. A central notion still adhered to today was developed in 'the infant industry argument', which in its broad meaning is often used as a justification of different sorts of government interventions during the first 'kick-off' stage of economic development. This 'infant industry argument' starts from the observation that new firms in developing countries, simply because of their high initial costs of production, are unable to compete with well-established firms in developed countries and, as a result, should be temporarily protected by the government from competition. This *temporary* government shelter in the form of import restrictions (protection) and subsidies (promotion), offers the 'infant firm' breathing space to grow up so as to cover high initial costs (static scale economies[205]) and/or to 'learn by doing' (dynamic scale economies[206]) and hence to cut its

[203] Directly purchasing international knowledge, acquiring it through telecom systems, or the movement of people are other channels of knowledge spillovers across the board. Brahmbhatt and Hu, above n 200, at 6, 13; B. M. Hoekman, K. E. Maskus, and K. Saggi, 'Transfer of Technology to Developing Countries: Unilateral and Multilateral Policy Options', *IBS, Research Program on Political and Economic Change, Working Paper PEC 2004-2003* (May, 2004), 34 pp.; R. Baldwin, H. Braconier, and R. Forslid, 'Multinationals, Endogenous Growth, and Technological Spillovers: Theory and Evidence', 13:5 *Review of International Economics* (2005), 945–963; W. Keller and S. R. Yeaple, 'Multinational Enterprises, International Trade, and Productivity Growth: Firm-Level Evidence from the United States', 91:4 *The Review of Economics and Statistics* (2009), 821-831; W. Keller, 'Transfer of Technology', in S. N. Durlauf and L. Blume (eds), *New Palgrave Dictionary of Economics*, 2nd ed. (London: Palgrave Macmillan, 2008), 367-371; W. Keller, 'Trade and the Transmission of Technology', 7 *Journal of Economic Growth* (2002), 5-24.

[204] See Brahmbhatt and Hu, above n 200, at 6-7; Hoekman, Maskus, and Saggi, above n 203, at 12; World Trade Report 2008, above n 125, at 157-160.

[205] These static economies of scale are represented by a downward-sloping long-term average cost function.

[206] Dynamic scale economies refer to situations in which costs fall with cumulative production over time (shift downward of long term average cost curve), rather than with the actual level of production. See P. Succar, 'The Need for Industrial Policy in LDC's - A Re-Statement of the Infant Industry Argument', 28:2 *International Economic Review* (June, 1987), 521-534, at 521, footnote 2.

average production costs over time.[207] Once the firm has become mature, the argument assumes, it will be capable to compete on the international market without further government support. In the presence of market failures, even a perfectly functioning capital market might not provide sufficient credit to bridge this initial phase.[208] Whereas such promotion or protection would be welfare-reducing from a static perspective,[209] it would generate dynamic welfare benefits (i.e., over time) by initiating the establishment of internationally competitive and productive industries.[210] Such policy might even boost world welfare by reducing world prices if the mature firm turns out to be more productive than previously established foreign rivals in developed countries or if its entrance creates more competition in non-competitive (e.g., oligopolistic or monopolist) markets.[211]

In the 1950s and 1960s, several developing countries put the infant industry argument into practice by adopting an import-substitution (IS) strategy, which sheltered domestic firms from foreign competition by a variety of import restrictions such as tariffs and quantitative restrictions (QRs) on final manufactured goods, combined with prioritizing intermediate and capital goods (and fuel) imports.[212] Such substitution by domestic final production was indirectly biased against exports as it channeled resources away from actual or potential export industries.[213] Aggravated by an appreciation of exchange rates resulting from the

[207] If no dynamic scale economies would exist, a non-recurring subsidy would be sufficient to cover initial start-up costs (static scale economies). Next to internal economies of scale (cost per unit depends on the size of an individual firm), external economies of scale (cost per unit depends on the size of the industry and not on the size of an individual firm) could be an argument for infant industry protection (see below Rodriguez-Clare on clustering; see below Part I, Chapter 2, Section 2.4.2.2). This temporal aspect of the infant industry argument is also reflected in Article XVII GATT: 'promote the rapid development of domestic industries'. P. A. Messerlin, 'Enlarging the Vision for Trade Policy Space: Special and Differentiated Treatment and Infant Industry Issues', *The World Economy* (2006), 1359-1407.

[208] Evidently, a perfectly functioning capital market is often absent in developing countries.

[209] From a static welfare perspective and assuming the entrance of a monopolist (i.e., no other producer is present), a subsidy might also be welfare increasing in case of static economies of scale. If a monopolist's average cost of production is higher than the potential market price (marginal costs equal marginal benefits), no production would occur (welfare is zero). A subsidy covering this difference would induce production and be welfare increasing if its cost is lower than the benefit to consumers. In fact, this may be an argument for permanent subsidization. But if entry is promoted in a market where another firm already sells profitably without government support (duopoly), the welfare effect should also take into account the negative effect on the latter's profit. Grossman, above n 66, at 96-98.

[210] See below Part I, Chapter 2, Section 2.4.3.

[211] Of course, this assumes that production is sufficiently large to decrease the world price (large country assumption). For example, the firm would exploit the intrinsic relative comparative advantage of the developing country in the sector in question. See also H. Pack and K. Saggi, 'Is There a Case for Industrial Policy? A Critical Survey', 21:2 *The World Bank Research Observer* (Fall, 2006), 267-297, at 269. In oligopolistic or monopolist markets however, new entrance might also result in production at an inefficient scale (e.g., if fixed costs are very high).

[212] The goal was to replace the production of final stage imported goods by domestically produced final goods (e.g., automobiles) in the first phase and to protect intermediate goods (e.g., automobile parts) in the second phase so as to launch a domestic industry in intermediate products.

[213] Firms were stimulated to produce for the protected domestic market where they received a higher price than on the world market. Krugman and Obstfeld, above n 104, at 258-259. Bhagwati defines an IS-strategy as the adoption of an effective exchange rate for the country's exports (which includes

import restrictions itself, this anti-export bias equally formed a deliberative policy choice because an overvalued exchange rate made the importation of intermediate and capital goods cheaper.[214] The IS-strategy also attracted FDI which aimed at circumventing the tariff/QR wall (tariff-jumping FDI).[215] The objective was to diversify out of agriculture into manufacturing as reliance on primary exports would deteriorate its terms of trade (the Prebish-Singer thesis).[216] Hence, this process of industrialization would kick off by encouraging the importation of intermediate and capital goods and by discouraging imports of manufactured goods and exports of primary goods. This inward-oriented policy emerged from a belief that exporting manufactured goods was simply impossible in the short run (so-called 'export pessimism'; economic argument) and from the influence of an influential lobby in import-competing sectors that remained absent at the export side (political-economy argument).[217] Once the industry had grown up by selling in the protected domestic market, it would be able to produce for the international market as well. The import-substitution phase was thus seen as a prerequisite to be satisfied before a country could enter the phase of exporting manufacturing goods.

By the late 1960s and the beginning of the 1970s, distortions generated by the IS-strategy came more and more to the surface.[218] Unemployment amplified, capital remained underutilized, and total factor productivity had not improved significantly. Instead of having 'learned by doing', many infant firms never grew up as they invested in successfully capturing their governments to keep protection walls standing (rent-seeking behavior).[219] As a consequence, the price of their products remained well above world prices, hurting domestic consumers and downstream industries. Moreover, there was a shortage of export earnings as

export subsidies) which is less than that for imports (which includes import charges). This creates an 'anti-export bias' (i.e., an overall incentive to import-substitute relative to what international prices dictate). J. N. Bhagwati, 'Export-Promoting Trade Strategy, Issues and Evidence' 3:1 *World Bank Research Observer* (January, 1988), 27-57, at 32.

[214] In line with the Harrod-Domar model, capital was understood to be the main engine of growth. The overvalued exchange rate was welcomed as it discouraged the traditional exportation of primary goods, making resources available for the manufacturing sector.

[215] Bhagwati, above n 213, at 27-57.

[216] At the same time, developing countries emphasized the importance of enhanced market access on primary product markets in developed countries. WTO Secretariat, *World Trade Report 2003* (Geneva: WTO Publications, 2003), 242 pp., at 152.

[217] Krugman and Obstfeld, above n 104, at 258-259.

[218] Nonetheless, the period of 1950s and early 1960s (the so-called 'easy stage of import-substitution') had offered some promising results. World Trade Report 2006, above n 9, at 66; Commission on Growth and Development, above n 149, at 21; J. A. Frieden, *Global Capitalism – Its Fall and Rise in the Twentieth Century* (New York, W.W. Norton & Company, 2006), 556 pp., at 351-356. The downsides of the import-substitution strategy also generated a shift in thinking on Special and Differential treatment (S&D treatment) in the GATT (Tokyo Round), whereby the focus shifted to developing countries' own trade policies as well as on market access for their exports. World Trade Report 2003, above n 216, at 153.

[219] World Trade Report 2006, above n 9, at 66.

industries failed to start exporting.[220] At the same time, the exceptional growth rates of East Asian countries started to attract attention of policymakers and scholars.[221] Although the exact formulae of their success was and still is debated, it was generally recognized that these countries had shifted timely from an IS-strategy to an export promotion (EP) strategy, facilitating a fast technological catch-up.[222,223] The neoclassical or neoliberal reading of this success stressed the role of the market and outward orientation but, as the revisionist or structuralist view correctly criticized, overlooked the fact that in several of these countries (e.g., Japan, Korea, Taiwan) government interventions were central for explaining their successful EP-strategy.[224] The neoclassical school's mistrust of government interventions also emerged from the negative experience with the extended IS-strategy adopted in Latin America and Sub-Saharian Africa.[225] Still, this neoclassical but one-sided reading was adopted by the World Bank and IMF as well as by US government agencies during the 1980s and resulted in the 'Washington Consensus', as labeled by Williamson.[226] This Consensus prescribed an outward orientation strategy with minimal government intervention. Hence, under the Washington Consensus, an export 'promotion' strategy was a trade-neutral or 'free trade' strategy with no significant intervention: the benefits of exportation were highlighted and governments were prescribed to refrain from policies with an anti-export bias.[227] Indeed,

[220] Failing export earnings resulted in a shortage of foreign exchange, needed to finance imports of capital and intermediate goods. Exchange controls (e.g., those prohibiting exporters to hold their earnings abroad) were imposed to ensure that foreign exchange was used for the importation of those goods. A. O. Krueger, 'Why Trade Liberalisation is Good for Growth', 108:450 *The Economic Journal* (September, 1998), 1513-1522, at 1516.

[221] From a theoretical side as well, the IS-strategy became subjected to severe criticism for a first time by an influential paper by R. E. Baldwin, 'The Case against Infant-Industry Tariff Protection', 77:3 *Journal of Political Economy* (May - June, 1969), 295-305.

[222] Bhagwati observed in the literature, an *EP-strategy* also captures strategies that are neutral against imports and exports. These could equally be called 'trade-neutral' or 'bias-free' strategies or, as labelled by Krueger, as 'outer-oriented strategies'. Therefore, Bhagwati proposed to label a strategy with a neutral incentive regime as an EP-strategy and a strategy with a net incentive for exporting as an ultra EP-strategy, although an EP-strategy in most literature covers both. Bhagwati, above n 213, at 32-33; Krueger, above n 220, at 1514.

[223] World Trade Report 2003, above n 216, at 67.

[224] Authors belonging to the neoliberal school in the 1980s included Von Hayek, Buchaman, Krueger, and Depaak Lal. On the difference between the neoliberal and structuralist approach, see S. Lall, 'Strategy: The Role of the State in the Face of Globalization', in K. P. Callagher (ed), *Putting Development First – The Importance of Policy Space in the WTO and the International Financial Institutions* (London: Zed Books, 2005), 301 pp., 33-68, at 33-34.

[225] World Trade Report 2006, above n 9, at 67.

[226] See J. Williamson, 'What Washington Means by Policy Reform', in J. Williamson (ed), *Latin American Adjustment: How Much Has Happened?* (Washington DC: Institute for International Economics, 1990), 7-20.

[227] Bhagwati also underlined that, even in the meaning of a trade neutral strategy, an EP-strategy should not necessarily be equated with the absence of government intervention. To the contrary, 'such intervention can be of great value, and almost certainly has been so, in making the EP-strategy work successfully' because:

> 'By publicly supporting the outward-oriented strategy, by even bending in some cases toward ultra-export promotion, and by gearing the credit institutions to supporting export activities in an

the elimination of barriers to importation and FDI were listed among the ten elements of the Washington Consensus.[228] Generally speaking, the Washington consensus reflected a conviction that government failures were far more prevalent than market failures. Therefore, the legitimate role for governments was confined to guaranteeing a stable macro economic environment, enforcing property rights, and providing essential public goods such as education and global infrastructure.[229] According to Lall, this Washington Consensus also found its way to the new trade rules drafted during the Uruguay Round.[230]

In a pivotal 1993 study, the World Bank revised its explanations for the exceptional high growth rates in the East Asian region between 1965 and 1990, commonly known as the 'East Asian Miracle'.[231] In the first stage, East Asian countries often combined import protection with an EP promotion strategy, for example by exempting exports from import duties (e.g., export processing zones) before gradually liberalizing imports.[232] Yet, assistance to exporters went much further than undoing the disincentives created by import barriers and thus 'getting prices right', but included guaranteed financing, tax incentives, subsidized infrastructure, FDI incentives, and other types of subsidies for exports.[233] Importantly, it was also recognized that there was no single East Asian model: the East Asian countries significantly differed in the way they employed these export incentives[234] and even within one country the strategy varied over time. Indeed, a key to the East Asian success was the policy flexibility put in place: strategies were revised if deemed necessary in light of changing international or national circumstances or if previous strategies turned out to be unsuccessful.[235] This is what Stiglitz called the high 'adaptability' of East Asian countries.[236] Overall, an essential

> overt fashion, governments in these countries appear to have established the necessary confidence that their commitment to the EP-strategy is serious'.

This aspect is not recognized under a laissez-faire model. Bhagwati, above n 213, at 33-34.

228 The recipe of the Washington Consensus is often summarized in the catch-phrase: 'stabilize, privatize, and liberalize'. Commission on Growth and Development, above n 149, at 5.

229 S. Lall, 'Reinventing Industrial Strategy: The Role of Government Policy in Building Industrial Competitiveness', *QEH Working Paper Series* No. 111 (October 2003), 35 pp., at 2; M. Noland and H. Pack, *Industrial Policy in an Era of Globalization: Lessons from Asia* (Washington DC: Institute for International Economics, 2003), 144 pp., at 5-6. According to the World Trade Report 2006, the suspicion of targeted government interventions was 'itself largely based on anecdotal evidence and stylized facts'. World Trade Report 2006, above n 9, at 67.

230 Lall, above n 229, at 2.

231 The eight countries concerned were: Hong Kong, Indonesia, Japan, Korea, Malaysia, Singapore, Thailand, and Taiwan. World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (Oxford: Oxford University Press, 1993), 389 pp.

232 Except for Hong Kong that did not develop an early IS-strategy. World Bank Report 1993, above n 231.

233 World Bank Report 1993, above n 231, at 143;

234 For example, Hong Kong adopted a free market approach, whereas Korea and Taiwan adhered most intensively to an interventionist strategy.

235 World Bank Report 1993, above n 231, at 86, 145.

236 World Bank Report 1993, above n 231, at 154; J. E. Stiglitz, 'Some Lessons from the East Asian Miracle', 11:2 *The World Bank Research Observer* (August, 1996), 151-17, at 154.

ingredient of the East Asian success was attributed to a stable and well-functioning macro economic environment which kept the exchange rate stable and inflation, budget deficits, and external debt under control. In line with the endogenous growth theory, the World Bank further pointed to the benefits of booming exports, which accelerated economic growth through productivity improvements that result from technology spillovers (productivity-based catching up).[237] In this respect, the World Bank Report explicitly acknowledged the contribution of *functional* government interventions in explaining this export push, in particular those which targeted *exports* in general. For example, exporters had access to credits, often at subsidized rates.[238] In contrast, *selective* interventions which promoted specific industries or firms were considered less successful, except for Japan.[239] The World Bank acknowledged that some selective interventions in Japan, Korea, and Taiwan effectively shifted resources to high-yielding activities but again stressed that these resulted from close monitoring and interaction with the private sector.[240] In sum, the World Bank accepted that it was not the absence of governance interventions that turned the East Asian economies into 'a miracle' but that this miracle in fact showed how governments have a significant role to play in correcting market failures that are more widespread than previously understood. Yet, such interventions should be functional and aim at boosting exports in general, rather than being selective. After all, the record on selective interventions is mixed and the ones that were successful seem hard to duplicate elsewhere in the developing world.

Importantly, most authors at the neoliberal as well as at the structuralist side of the spectrum seemed to agree with several conclusions drawn by this World Bank study. There was no single East Asian Model, implying that there is no 'one size fits all' formula for economic development and indicating that adoption of similar policies is no guarantee for success. But even in absence of a single receipt, all East Asian countries shared a stable macro economic environment, an orientation on exports and investments in human resources, and an institutional framework which managed to avoid that markets and governments acted as antagonists.[241,242]

[237] World Bank Report 1993, above n 231, at 261, 316.

[238] The provision of credit to exporters was more successful than in other developing countries because, on average, credits contained a lower subsidy element and the intensive institutional cooperation between governments and the private sector reduced moral hazard behavior.

[239] Except for Japan, these selective interventions did not generate above average productivity gains nor did they result in changing industrial structure. The World Bank Report 1993 concludes 'that selective interventions were neither as important as their advocates suggest nor as irrelevant as their critics contend' but '(t)he most successful intervention (…) – the commitment to manufactured exports – was also the most general one'. World Bank Report 1993, above n 231, at 324-326.

[240] World Bank Report 1993, above n 231, at 325.

[241] See, for example, D. Rodrik, 'TFPG controversies, institutions, and economic performance in East Asia', *NBER Working Paper* No. 5914 (February, 1997), 37 pp., at 1; R. Hausmann and D. Rodrik, 'Economic development as self-discovery', 72 *Journal of Development Economics* (2003), 603– 633, at 604-605.

Yet, one particular aspect of the World Bank Report provoked an intense debate among economists and policymakers, crystallizing around the concept of 'industrial policy'.[243] In its broad meaning as also adhered to in this dissertation, industrial policy encompasses all government measures that to speed or alter the process of resource allocation among or within industrial or service sectors with the aim of correcting market distortions that inhibit economic growth.[244] If understood as such, not only specific interventions inducing certain specific industries but also functional or horizontal interventions inducing particular activities such as R&D and exports are considered part of a country's industrial policy strategy.[245] In many studies and in the 1993 World Bank Report, however, industrial policy is deemed to capture only those interventions that are selective in the sense of targeting specific sectors, even though the degree of specificity is often left undefined. As mentioned above, the World Bank Report largely rejected the case for an industrial policy defined in this narrow way.

At the neoliberal side of the spectrum, several scholars agreed with this reading and conclusion. Reviewing the literature on the East Asian Miracle, Noland and Pack for example conclude that only a minor part of the East Asian's growth success is attributed to selective interventions. Instead, they emphasized the importance of macro economic fundamentals and acknowledged the benefits of a slight pro-export bias.[246] Along the same lines, Pack and Saggi suggested that for other developing countries the original Washington Consensus receipt holds more promises than complex strategies of selective government interventions. Whereas the neoliberal school increasingly recognized the existence of significant market failures in developing countries, it stressed the difficulty of correcting these by selective interventions: 'picking winners' requires detailed information which governments likely miss and gives rise to rent seeking behavior and corruption.

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242 Market-friendly policies, prioritizing economic growth and maintenance of macro economic stability are in the words of Rodrik 'the sine qua non of economic growth'. D. Rodrik, 'Growth After the Crisis', *Paper Prepared for the Commission on Growth and Development* (May, 2009), 42 pp., at 7.

243 The difficulties in defining 'industrial policy' exactly reveal the divergence in views on the appropriate role of governments in the market. Other aspects of the World Bank study were equally disputed. For example, Lawrence and Weinstein have criticized the Report's narrow focus on exports as engines of economic growth, whereas imports were important sources of productivity growth through channelling knowledge spillovers and inducing innovation. R. Z. Lawrence and D. E. Weinstein, 'Trade and growth: import-led or export-led? Evidence from Japan and Korea', *NBER Working Paper* No. 7264 (July, 1999), 43 pp.

244 This definition is partly derived from Rutherford, above n 81, at 270. As Rodrik rightly indicates, the term 'industrial' policy might be somewhat misleading as it also refers to resource allocation in the service sector. For other broad definitions, see D. Rodrik, 'Normalizing Industrial Policy', *Working Paper* (September, 2007), 50 pp., at 3 ('policies that stimulate specific economic activities and promote structural change'). A list of definitions can be found in Z. Hernandez, 'Industrial Policy in East Asia: In Search for Lessons', *Background paper prepared for the World Development Report 2005* (September, 2004), 33 pp., at 5.

245 See Hernandez, above n 244, at 5. In this meaning, the World Bank, by emphasizing functional interventions such as exports, also preserved a role for industrial policy in the East Asian Miracle.

246 Yet, they left open the possibility that selective interventions could have had an important impetus for the *initial* phase of industrialization in Korea and Taiwan. Noland and Pack, above n 229, at 93-100.

At the structuralist or revisionist side of the spectrum, however, authors emphasized the success of selective interventions not only in several East Asian countries but also in high-income countries in their early stages of development.[247] Here, some convergence the neoliberal view emerged. Indeed, the structuralist school increasingly acknowledged the important role of private markets and the danger of government failures, certainly in case of selective interventions. According to Lall, the lower the government's capabilities, the lower the degree of selectivity it can be entrusted with.[248] Yet, these authors emphasize the risk of government failures should not refrain governments from taking action but should stimulate the improvement of government capabilities and ensure that efficient monitoring systems are put in place.[249] Market failures in developing countries are too fundamental to be left untouched.[250] Part of their argument is that the strengthening of disciplines under the WTO (or under regional/bilateral agreements and World Bank and IMF programmes) has to some extent foreclosed the potential of low-income countries to employ the type of industrial policies underpinning the East Asian Miracle.[251] This conclusion was also reached by the 2006 UNCTAD Trade and Development Report.[252]

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[247] See, for example, Lall, above n 224, at 46-48. A recent example is given by Barnes et al in reporting the success of selective policy interventions (through export incentives) in the South-African Automobile Sector. This suggests a useful role for selective targeting. J. Barnes, R. Kaplinsky, and M. Morris, 'Industrial Policy in Developing Economies: Developing Dynamic Comparative Advantage in the South African Automobile Sector', 8:2 *Competition & Change* (June, 2004), 153–172.

[248] S. Lall, 'Selective Industrial and Trade Policies in Developing Countries: Theoretical and Empirical Issues', *QEH Working Paper Series* (April, 2000), 38 pp., at 28-29.

[249] In the words of Hausman et al: 'many promoted activities will necessarily fail. But this is as it should be. The absence of failure is a sure sign that the government's industrial policies were too timid. The ultimate test of whether industrial policy is working is not whether a government can reliably pick winners (no government reliably can) but whether a government is able to let losers go'. R. Hausmann, D. Rodrik, and C. F. Sabel, 'Reconfiguring Industrial Policy: A Framework with an Application to South Africa', *CID Working Paper* No. 168 (May, 2008), 22 pp., at 12; see also Rodrik, above n 244, at 42; J. E. Stiglitz, 'Development Policies in a World of Globalization', in K. P. Callagher (ed), *Putting Development First – The Importance of Policy Space in the WTO and the International Financial Institutions* (London: Zed Books, 2005), 15-32, at 27.

[250] In recent writings, the importance of the *process* of industrial policy is also underlined, which would minimize the risk of government failures. See, for example, Hausmann, Rodrik, and Sabel, above n 249.

[251] See, for example, Rodrik, above n 161, at 148-149; D. Rodrik, 'How to Save Globalization from its Cheerleaders', *Working Paper* (September, 2007), 33 pp., at 24; Lall, above n 248, at 30-31; Y-S. Lee, 'Facilitating Development in the World Trading System – A Proposal for Development Facilitation Tariff and Development Facilitating Subsidy', 38:6 *Journal of World Trade* (2004), 935-954; J. S. Mah, 'Export Promotion and Economic Development: The Case of Korea', 40:1 *Journal of World Trade* (2006), 153-166; S. M. Shafaeddin, 'Towards an Alternative Perspective on Trade and Industrial Policy', 36:6 *Development and Change* (2005), 1144-1162; H-J. Chang, 'Kicking Away the Ladder: "Good Policies" and "Good Institutions" in Historical Perspective', in K. P. Callagher (ed), *Putting Development First – The Importance of Policy Space in the WTO and the International Financial Institutions* (London: Zed Books, 2005), 102-125. But Amsden, who also pleads for sufficient policy space for industrial policy, has concluded that WTO rules are overall sufficiently flexible to this end. See A. H. Amsden, 'Promoting Industry under the WTO', in K. P. Callagher (ed), *Putting Development First – The Importance of Policy Space in the WTO and the International Financial Institutions* (London: Zed Books, 2005), 301 pp., at 216-232; A. H. Amsden and T. Hiking, 'The Bark

In recent years, the World Bank has emphasized that market failures in low income countries are deeply rooted and that governments have an important role to play in correcting these market failures. Significantly, the World Bank even started to accept that *selective* policies might be part of a broader agenda to overcome market failures and to implement an EP-promotion or outward-oriented industrial policy.[253] In an important 2009 study, the World Bank stressed that low-income countries should prioritize the correction of market failures affecting *export diversification*, given that such diversification is seen as pivotal for economic growth.[254] The study underlined the importance of export diversification for economic growth as it unleashes productivity-inducing externalities (e.g., knowledge spillovers), progressively facilitates more rapid moves to a better allocation of production factors,[255] and tempers macro economic volatility (portfolio effect)[256] as well as the vulnerability for elite

Is Worse Than the Bite: New WTO Law and Late Industrialization', 570 *Annals of the American Academy of Political and Social Science* (July, 2000), 104-114.

[252] UNCTAD, *Trade and Development Report, 2006 – Global Partnership and National Policies for Development* (New York: United Nations Publications, 2006), 237 pp., at 169.

[253] Although the 2005 World Development Report already acknowledged that growth could possibly be accelerated by selective interventions, it remained largely sceptical of their use. In its 2008 World Economic Prospect, the World Bank, however, emphasized that governments have an important role in overcoming market failures in developing countries and listed successful industry-specific and product-specific interventions. World Bank, *World Development Report 2005 - A Better Investment Climate for Everyone* (New York: World Bank and Oxford University Press, 2005), 271 pp., at 157-174; World Bank, *Global Economic Prospects 2008 - Technology Diffusion in the Developing World* (Washington DC: The World Bank, 2008), 201 pp., at 142-145.

[254] R. Newfarmer, W. Shaw, and P. Walkenhorst (eds), *Breaking into New Markets – Emerging Lessons for Export Diversification* (Washington DC: The World Bank, 2009), 265 pp. Parallel to the findings by Imbs and Wacziarg on the pattern of domestic production in relation to income, an inverted U-shaped relationship between export diversification and income is found: in the first phase of development countries diversify their exports, whereas they start specializing at a certain level of income and diversification thus falls. Of course, this U-shaped relationship (merely revealing a positive correlation) does *an sich* not imply that export diversification spurs economic growth in low-income countries. As Brenton et al observed, 'in one sense, the causality runs from growth to diversification' but, for the reasons spelled out in the full text, diversification is also considered to lead to higher growth. Hesse finds 'some robust empirical evidence of a positive effect of export diversification on per capita income growth'. Theoretical arguments for specialization are the Ricardian theory of trade (specialization resulting from falling barriers-to-trade such as lower tariffs and transport costs) and agglomeration economies (clustering). P. Brenton, R. Newfarmer, W. Shaw, and P. Walkenhorts, 'Breaking Into New Markets: Overview', in R. Newfarmer, W. Shaw, and P. Walkenhorst (eds), *Breaking into New Markets – Emerging Lessons for Export Diversification* (Washington DC: The World Bank, 2009) 1-35, at 2 and 6-7; H. Hesse, 'Export Diversification and Economic Growth', R. Newfarmer, W. Shaw, and P. Walkenhorst (eds), *Breaking into New Markets – Emerging Lessons for Export Diversification* (Washington DC: The World Bank, 2009), 55-80, at 56-57; J. Imbs and R. Wacziarg, 'Stages of Diversification', *The American Economic Review* (March, 2003), 63-86, at 82; O. Cadot, C. Carrère, and V. Strauss-Kahn, 'Export Diversification: What's behind the Hump?', *CEPR Discussion Papers* No. 6590 (November, 2007), 46 pp.

[255] Cumulative investments in traditional activities will in most cases exhaust activity-specific economies of scale and lead to stagnating or decreasing returns. See also R. Hausmann, J. Hwang, D. Rodrik, 'What You Export Matters', 12:1 *Journal of Economic Growth* (March, 2007), 1-25.

[256] Openness makes a country vulnerable to external shocks by increasing volatility of output, which negatively affects growth and private investment. Export diversification into *new* products (product diversification) could reduce the vulnerability to price shocks (i.e., shocks to the prices of imported and exported products), but diversification of existing products into new markets (geographical diversification) could also be important to soften the vulnerability to country-specific shocks in

capture. However, contrary to conventional wisdom (e.g., Prebish-Singer thesis[257]), concentration *an sich* and not its dependency of commodities seems to be negatively correlated with growth, hereby suggesting that the call for diversification should not necessarily mean diversifying *out* of commodities into manufacturing.[258] The concept of export diversification does not only mean exporting 'new' products that were not exported previously from the low-income country in question ('product diversification'), but also covers the penetration of new export markets by existing exports ('geographical diversification').[259] Because market failures inhibit (the speed of) such export diversification, developing countries – in particular low-income countries – should be supported in implementing an *explicit* policy of diversifying exports that should consist of a mix of general – affecting all firms and consumers – and specific interventions. The general framework includes macro economic stability, rectifying any anti-export bias, lowering the cost of trade-related services (e.g., telecommunications, finance), as well as proactive policies to support trade (e.g., public-private cooperation, export promoting agencies, agencies to support innovation and clusters, export processing zones, and duty refund schemes).[260] Further, the World Bank study called for specific interventions for 'particular industries through tax, credit, and budget subsidies' to correct market failures and hereby acknowledges that, 'in fact, most countries have some *de facto* policies that stimulate specific economic activities'.[261] In order to ensure that such industrial policy promotes instead of impedes structural change, it should be transparent, well-focused, and flexible.[262] Hence, the risk of government failures, which could 'make things worse', no longer seems to serve as an argument to leave market

exporting markets. M. Bacchetta, M. Jansen, C. Lennon, and R. Piermartini, 'Exposure to External Shocks and the Geographical Diversification of Exports', in R. Newfarmer, W. Shaw, and P. Walkenhorst (eds), *Breaking into New Markets – Emerging Lessons for Export Diversification* (Washington DC: The World Bank, 2009), 81-100, at 97.

[257] This thesis suggested that exporters of natural resources would face a decline in terms of trade over time.

[258] D. Lederman and W. F. Malony, 'Trade Structure and Growth', in R. Newfarmer, W. Shaw, and P. Walkenhorst (eds), *Breaking into New Markets – Emerging Lessons for Export Diversification* (Washington DC: The World Bank, 2009), 39-54. Next to the terms of trade argument, however, Hesse refers to the volatility of commodity markets and holds that diversifying into other products could stabilize export earnings (i.e., portfolio argument). Equally, according to Cadot et al, the evidence for the Prebish-Singer hypothesis is fairly strong. Hesse, above n 254, at 56-57; Cadot, Carrère, and Strauss-Kahn, above n 254, at 2.

[259] Yet, the 2009 World Bank study also underlined that the primary source of export growth consists of increases in *existing* bilateral trade flows (the intensive margin), rather than in increases in 'new' products or 'new' markets (the extensive margin). Within the extensive margin, exporting to 'new' markets (geographical diversification) mostly contributed to export growth. Brenton, Newfarmer, Shaw, and Walkenhorts, above n 254, at 4. See also Messerlin, above n 207, at 1400-1401.

[260] The 2009 World Bank study also pointed to the mixed result of export processing zones. Brenton, Newfarmer, Shaw, and Walkenhorts, above n 254, at 23-24 and 27-28.

[261] Brenton, Newfarmer, Shaw, and Walkenhorts, above n 254, at 25.

[262] In particular, a four-step approach is suggested: (i) the current incentive regime should be mapped; (ii) its cost price should be calculated and made public; (iii) its achievements should be assessed; and (iv) its content should be reconfigured around a national programme of competiveness.

failures untouched but should be addressed in the design of the industrial policy programme itself.[263] As the 'trick is to identify the shortcomings of the marketplace and then tailor the right combination of tax, tariff, and subsidy policies to offset those shortcomings and promote growth',[264] insight in the particular market failures impeding export diversification and economic growth in general seems pivotal.

2.4.2. Identification of specific market failures calling for an industrial policy

The standard rationale for the infant industry argument rests on the assumption of a capital market failure. Indeed, under a perfectly functioning capital market, there seems to be no reason why the private market would not finance 'infant industries' so as to bridge the learning phase (dynamic) or to set-up a sufficiently large plant (static).[265] A subsidy or import restriction would at most serve as a second-best option as fixing the capital market imperfections would be optimal.[266] Yet, and somewhat related to the case for R&D subsidies, subsidizing 'infant industries' is warranted in case their learning spills over to other actors in the economy (intra- or inter-industry) given that the capital market would not compensate infants for generating such *external* benefits.[267] Two other, though interrelated, market failures recently received renewed attention for underpinning the case for industrial policy.[268] Even if capital markets function perfectly, potentially competitive industries could be inhibited from popping up (or expanding their activities), either by the risk that the discovery of first-movers might be copied by imitators or by the failure of private actors to coordinate their complementary actions.[269] Starting from the angle of each of these types of market failures, our discussion turns to the World Bank's advice on how to stimulate product (Section 2.4.2.1) and geographical (Section 2.4.2.2) diversification, respectively.

[263] In the words of the 2009 World Bank study, 'industrial policies can help, but they have to be carefully designed and administered to avoid private capture'. R. Newfarmer, W. Shaw, P. Walkenhorst (eds), *Breaking into New Markets – Emerging Lessons for Export Diversification* (Washington DC: The World Bank, 2009), 265 pp., at xxiii.
[264] Brenton, Newfarmer, Shaw, and Walkenhorts, above n 254, at 29.
[265] See, for example, Meade, above n 31, at 256; Baldwin, above n 221, at 297; Pack and Saggi, above n 211, at 270.
[266] Baldwin, above n 221, at 297; Krugman and Obstfeld, above n 104, at 258; World Trade Report 2006, above n 9, at 60.
[267] See Succar, above n 206, at 521-534; Baldwin, above n 221, at 297-300, 303-304.
[268] See, for example, Rodrik, above n 161, at 102; Hausmann, Rodrik, and Sabel, above n 249. These market failures are labelled 'new', not so much because they were revealed recently, but because they have gained renewed attention and acceptance (see, for example, below n 273). Moreover, other types of market failures are often attached to these types of market failures.
[269] Indeed, the capital market would not take into account the benefits generated by an investment which spill over to other actors and are thus not appropriable by the investor.

2.4.2.1. Information failures, discovery, and the search for product diversification

Hausmann and Rodrik point to an information externality hampering product diversification in a developing country and its transformation into a modern economy.[270] Entrepreneurs looking for more productive activities than those traditionally produced in these countries have to 'discover' which nontraditional products could be produced at low enough costs to be competitive on the world market. Contrary to traditional R&D investments (see above), this process does not directly aim at inventing new products or higher quality variants ('on-the-frontier innovation'). Rather, it seeks to discover which products already provided on the world market could be produced locally at world market prices ('inside-the-frontier innovation'[271]). Yet, this self-discovery process is neither self-evident nor costless. A lot of uncertainty is involved in finding out which products are profitable as the labor productivity model (Ricardo) and factor-endowment model (Heckser-Ohlin) only roughly explain the specialization of countries.[272] This cost of discovery is borne by the initial investor but his investment, if successful, has a 'demonstration effect' on others to enter this profitable market without having to make the initial sunk cost (free rider problem).[273] Assuming that entry in the profitable market is free (no or low barriers to entry; see below),[274] this information externality implies that market forces lead to underinvestment in self-discovery and thus in underproduction of nontraditional, high-productivity products in developing countries. As a result, governments in developing countries should encourage entrepreneurship and investment in nontraditional industries *ex ante* while, *ex post*, phasing out those investments that turn out to be unproductive (sunset clause). As Hausmann and Rodrik argue, an optimal

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[270] Hausmann and Rodrik, above n 241, at 603– 633; D. Rodrik, 'What's So Special About China's Exports?', *CEPR Discussion Paper* No. 5484 (February, 2006), 27 pp.

[271] These terms are employed by B. Klinger and D. Lederman, 'Diversification, Innovation, and Imitation of the Global Technology Frontier', in R. Newfarmer, W. Shaw, and P. Walkenhorst (eds), *Breaking into New Markets – Emerging Lessons for Export Diversification* (Washington DC: The World Bank, 2009), 101-110, at 103.

[272] For example, these models fail to explain why the IT sector in India is profitable or why Pakistan exports bed sheets but no hats, while both are labor-intensive.

[273] Analyzing the East Asian Miracle, Krugman has also sketched out this idea in 1989, labelling it as the 'It' theory:

> 'Firms may not know whether they can produce profitably in a country until one of them tries it. That is, some countries have "It," the ability to produce manufactures competitively, while others do not, and the only way to find out if a country has It is to try producing there. Yet to try producing, a firm must make a significant investment, much of which cannot be recovered if a country doesn't turn out to have what it takes. Countries that really have It do not get a chance to prove it if nobody takes the risk. (…) Suppose that a change in policies makes a few businesses domestic or foreign willing to try exporting manufactures. Then the country may suddenly find itself "discovered" (or may discover itself)'.

Interestingly, Krugman predicted that China (and Mexico) also have 'It'. P. R. Krugman, 'Developing Countries in the World Economy', 118:1 *Daedalus* (Winter, 1989), 183-210, at 191.

[274] To be precise, this holds true as long as entry is not retarded until the sunk cost is recovered. Contrary to on-the-frontier innovations, such inside-the-frontier innovations cannot be protected by intellectual property rights. See Klinger and Lederman, above n 271, at 101; Hausmann and Rodrik, above n 241, at 606.

instrument therefore has to have the feature of a carrot-and-stick strategy. A subsidy (e.g., in the form of government loans or guarantees) has the benefit that it could discriminate between 'first movers' in nontraditional sectors and imitators/copycats but could lead to moral hazard behavior and too much diversification. On the other hand, trade protection is not an optimal instrument as it fails to differentiate between innovators and imitators and focuses on innovations in the narrow domestic market, hereby generating smaller social benefit than innovations targeting the larger world market. Although equally failing to discriminate between innovators and imitators, an export subsidy might be more suited as it directs innovations at the world market and offers a straightforward criterion to filter out unsuccessful innovations *ex post* (performance criteria).[275] Hausmann and Rodrik argue that the East Asian countries were so successful because they adequately employed a carrot-and-stick strategy by extending export subsidies and thus subsidize (carrot) only those industries able to export (stick).[276] In contrast, Latin American's poor growth record under the IS-strategy was a consequence of too much promotion (carrot) without discipline (stick), whereas its weak performance in the 1990s might have resulted from the opposite policy, namely too much discipline without promotion as mandated by the Washington Consensus recipe.

Next to the demonstration effect of a profitable activity, the first mover generates other positive spillovers for which he is not compensated. First, the technology embodied in foreign products is often 'tacit' and has to be adapted to local circumstances which demands substantive investments.[277] Yet, given that this process is mostly not patentable, such locally adapted technology spills over on other firms entering the profitable market (knowledge spillover).[278,279] Further, the first mover might have invested in specific on-the-job training but such labor training might again benefit other firms if they engage these trained workers.[280] Next, the first mover might have built a reputation in foreign markets, and this reputation

[275] Hausmann and Rodrik, above n 241, at 629-630.

[276] According to Hausmann and Rodrik, '(n)ew international agreements in the context of the World Trade Organization have made such subsidies illegal'. Yet, this statement fails to take into account the S&D treatment offered to some low-income countries to offer export subsidies. Hausmann and Rodrik, above n 241, at 630.

[277] Hausmann and Rodrik, above n 241, at 624.

[278] Contrary to R&D innovations, existing technologies adapted to local circumstances are indeed mostly not patentable and developing countries often also lack efficient patent laws (see above n 274). Somewhat parallel to the case for R&D subsidies, a perfectly functioning capital market would not compensate firms for the benefits of learning which spills over to others intra- or inter-industry (above n 267).

[279] See also W. F. Schwartz and E. W. Harper, 'The Regulation of Subsidies Affecting International Trade', 70:5 *Michigan Law Review* (April, 1972), 831-858, at 847.

[280] See Baldwin, above n 221, at 300-301. According to Baldwin, government intervention might not be needed given that workers, as beneficiaries, will invest (by accepting lower wages or borrowing on the capital market) in such on the job training.

might benefit new entrants if it is linked to the country of production.[281] These free rider problems in R&D investments, worker training, and reputation would justify subsidies stimulating these activities. As mentioned above, tariff protection would be inferior to correct such domestic market failures as it creates an extra distortion (consumers paying a higher price).

Relevantly, the World Bank study on export diversification includes a study by Klinger and Lederman that presents empirical support to underpin Hausmann and Rodrik's hypothesis that free riding of imitators hampers inside-the-border innovations in developing counties and thus the diversification of the economy in developing countries.[282] Indeed, they have found that barriers to entry encourage discovery by reducing the impact of imitators on the return to discovery of the first-mover.[283] To be sure, they do not plead for constructing such barriers to entry as a way to spur discovery because such barriers are correlated to lower levels of private sector development, lead to under-specialization by scaling down imitation,[284] and protect beneficiaries from market discipline.[285] Instead, imitation should be encouraged rather than hampered and the best way to tackle the under-investment in self-discovery is to offer 'public support for experimentation in new sectors and activities'.[286] Similarly to the case for R&D investments for on-the-frontier innovations (above Section 2.3), laissez-faire is thus not an optimal policy for inside-the-frontier innovations but an activist industrial policy is required.[287]

At the same time, the same World Bank study also acknowledged that, in fact, such threat of imitation might not always reduce first-mover profits and thus discourage innovation. In particular, Nassif found that first movers in her case study were mostly hampered by limited access to finance and did not regard imitators as a threat. Instead, they were experienced as an opportunity to achieve economies of agglomeration (clustering; external scale economies), to

[281] See Klinger and Lederman, above n 271, at 108; Schwartz and Harper, above n 279, at 847.

[282] They also found confirmation for the U-shaped relationship between export diversification and growth (above n 254). Klinger and Lederman, above n 271, at 101-110.

[283] Entry barriers were measured on the basis of the costs and delays of starting a new business, enforcing contracts and hiring employees. Klinger and Lederman not only confirm that export growth has a positive and significant effect on the frequency of discoveries, but also found that the magnitude of this effect rises with the level of barriers to entry.

[284] Widespread imitation leads to efficient focusing of resources on the most efficient sector in the Hausmann and Rodrik model.

[285] Such barriers to entry would generate the IS-strategy's errors by not allowing the market to 'pick winners'. Klinger and Lederman, above n 271, at 108.

[286] Imitation is the 'channel through which through which the returns of inside-the-frontier' innovations are socialized. Klinger and Lederman, above n 271, at 108. For example, Nassif refers to the success of the Tunisian export promotion programme 'FAMEX', which specifically addressed business innovation by offering subsidies to firms with no previous export experience, to exporters of new products, and to exporters looking for new markets. C. Nassif, 'Promoting New Exports: Experience from the Middle East and North Africa', in R. Newfarmer, W. Shaw, and P. Walkenhorst (eds), *Breaking into New Markets – Emerging Lessons for Export Diversification* (Washington DC: The World Bank, 2009), 145-159, at 156.

[287] Hausmann and Rodrik, above n 241, at 606.

build reputation in export markets, or to lobby for better regulations or infrastructure.[288, 289] Overcoming such coordination failures seems particularly important for consolidating and expanding exports into new markets. We turn to this type of market failure in the next section.

2.4.2.2. Coordination failures, clustering, and the search for geographical diversification

2.4.2.2.1. The emergence of coordination failures

Many actions in the economy are complementary to actions of others, meaning that one agent's action increases the incentive for other agents to act similarly. Some actions might even only become viable if complementary actions by other agents are taken simultaneously. For example, an investment decisions to set up a factory might only be profitable if complementary downstream and upstream investments are made at the same time. If agents could coordinate these actions, they would all be profitable and a high equilibrium would thus be reached.[290] But if this coordination fails, no action is undertaken and the market might get stuck in a Pareto sub-optimal equilibrium.[291] Even though all private actors would be better off, coordination of actions might fail. This coordination failure can occur even if information is available on both options, for example because of low expectations that complementary investments will effectively be made or given the incentive upon all agents to wait upon others to move first (free rider problem).[292] According to big-push models of development, such coordination failures are widespread in developing countries, resulting in a low growth equilibrium trap.[293] Hence, governments should intervene in a way that pushes the economy

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[288] Moreover, if demand on the world market is limitless from the perspective of a developing country exporter, expanding supply by the entrance of imitators will have no or minimal effect on the first-mover. Hence, imitation in export markets is less a concern that in the more limited domestic market. But competition could become more critical as production expands and input supply (e.g., labor) becomes scarce. Another reason for Nassif's findings could result from the methodology used as it did not observe examples of failed discoveries. Brenton, Newfarmer, Shaw, and Walkenhorts, above n 254, at 11; Nassif, above n 286, at 150-153.

[289] Hence, a twofold approach should be developed: reduce the cost of experimentation (by crediting first-movers, along the lines suggested by Hausmann and Rodrik) but, at the same time, foster imitation without undermining the emergence of new activities (e.g., promote clustering). Nassif, above n 286, at 156-157.

[290] As both actions are profitable, a socially optimal output would indeed be achieved.

[291] A coordination failure occurs when agents' inability to coordinate their behaviour (choices) leads to an outcome (equilibrium) that leaves all agents worse off than in an alternative situation that is also an equilibrium. See M. P. Todaro and S. C. Smith, *Economic Development*, 9th ed. (Harlow: Pearson, 2006), 851 pp., at 808; see also K. Hoff, 'Beyond Rosenstein-Rodan: The Modern Theory of Underdevelopment Traps', *Working Paper* (April 2000), 56 pp., at 3.

[292] The latter will occur if there is a lag between the investment and the return on investment. Todaro and Smith, above n 291, at 145-146.

[293] For example, a past history of underdevelopment might lead to low expectations on future investments. This theory could explain why countries with similar fundamental characteristics could follow a radical different development path. Already in 1943, Rosenstein and Rodan laid the foundations for this theory.

to the high-investment equilibrium. Because all actions are viable if coordination is reached (high-level *equilibrium*), such intervention is only temporal and does not *ipso facto* require subsidization. Several government interventions could be installed. First, the government could act as a coordination facilitator between private actors, though this offers no guarantee that investments will effectively be made.[294] Second, the government could offer subsidies to induce investments, for example in the form of a guarantee,[295] Importantly, not all complementary actions should be subsidized to overcome the coordination failure because the set-up of one subsidized investment induces other private actors to make complementary investments, which in turn make the former investment profitable without further support.[296] However, the coordination failure argument on its own does not give much guidance on which actions should be chosen. Indeed, it is not a priori obvious which complementary actions will become viable (i.e., competitive) once made simultaneously.

In all cases, the emergence of coordination failures rests on one key assumption, namely the imperfect tradability (or proximity requirement) of inputs (goods, services, or technology). Obviously, if all inputs could be imported at no significant cost, no coordination among local agents would be needed and no multiple equilibria would arise. An investor could simply rely on imported inputs and its profitability would not depend on complementary local investments. Yet, imperfect tradability could result, for example, from high transportation costs of intermediate goods (e.g., 'pecuniary externality') but, according to Saggi and Pack, this assumption fails to recognize that most trade exactly takes place in such intermediate goods.[297] Alternatively, the requirement of proximity could be linked to producer services (such as consulting, machine repair, or telecommunications), labor, infrastructure, or the tacit nature of technology.[298] Indeed, whereas the traditional coordination failure argument was mainly grounded on the physical unavailability of inputs and is now largely superseded by the boost in international trade, its more recent underpinning refers to the tacit nature of knowledge and thus to the benefits of proximity (local knowledge spillovers).[299]

[294] In principle, the government could also command coordination. D. Rodrik, 'Coordination Failures and Government Policy: A model with Applications to East Asia and Eastern Europe', 40 *Journal of International Economics* (1996), 1-22, at 14.
[295] Rodrik, above n 161, at 108.
[296] See also Ray, above n 72, at 140.
[297] Noland and Pack, above n 229, at 276. Yet, Rodriguez-Clare refers to a study by Steinberg who found that even for small and open economies such as Singapore, domestic demand drives domestic production of tradable goods. Rodríguez-Clare, above n 184, at 5, footnote 12.
[298] Rodríguez-Clare, above n 184, at 4; A. Rodriguez-Clare, 'The Division of Labor and Economic Development', 49 *Journal of Development Economics* (1996), 3-32.
[299] Stiglitz also observed that the benefit of proximity (information flow between producers and users) explains why importation of intermediate goods does not serve as a perfect substitute for domestic production. See Stiglitz, above n 236, at 160-161.

Although imperfect tradability of inputs is a necessary condition, it is not sufficient for a coordination failure to arise. Indeed, multiple equilibria only emerge if an additional element ensuring that actions by different local agents are indeed complementary is present.[300] This additional condition could be fulfilled in several ways. First, most coordination failures' examples in the literature relate to downstream-upstream linkages. Hereby, the additional assumption of economies of scale in the intermediate goods market is formulated.[301,302,] Second, in case 'labor' is considered as non-tradable input, the coordination failure could arise between workers considering investing in training and firms considering investment in using technology that requires skilled-labor (high productivity).[303] Third, as elaborated above, knowledge spillovers are often complementary and could, according to Rodriguez-Clare, give rise to coordination failures.[304] The market failure resulting from the non-excludability of knowledge could lead to multiple equilibria: one in which firms decide to invest in modern technology[305] and one in which firms choose to use the backward technology.[306] Fourth, some actions might never become profitable (e.g., provision of public goods) and hence imply the absence of multiple equilibria, but are complementary to several other actions that become viable if the former investment is made. For example, infrastructure investment might have public goods characteristics (more or less non-excludable in developing countries) and too high fixed costs to be profitable but would still turn other private actions profitable.[307] In case

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[300] Here, this additional element makes the action of one agent dependent on (or influenced by) similar action by another agent.
[301] Rodrik, above n 294, at 14; Noland and Pack, above n 229, at 274-276; Rodriguez-Clare, above n 298, at 3-32.
[302] A higher variety of intermediate goods increases the productivity of the downstream industry and, in turn, a higher demand from the downstream industry increases the incentive to enter the intermediate good market. In order for the downstream industry to produce with the *modern* technology (higher productivity), a sufficient large amount of specialized intermediate producers should be present (love of variety). But if all firms use the backward technology (labor intensive), insufficient varieties of inputs are produced to make producing with the *modern* technology profitable, hence resulting in production with the traditional, backward technology. Only if a large number of firms use the modern technology, sufficient intermediate varieties are produced to enable the industry to produce profitable with the modern technology. As Rodriguez-Clare indicates, the emergence of multiple equilibria (producing with the traditional *or* modern technology) is indeed based on the assumption of economies of scale. Rodríguez-Clare, above n 184, at 4-5.
[303] In this case, coordination failures might arise because of thick effects related to search costs. The high equilibrium will only be reached if thick markets function such that firms and workers do not care about the risk of separation. This will only be the case if search costs are not too high to match with another modern firm/worker. Rodríguez-Clare, above n 184, at 5-6.
[304] Given that these spillovers attenuate with distance, the proximity requirement is also considered to be fulfilled. Rodríguez-Clare, above n 184, at 6-8.
[305] This is accompanied by spillover effects to other firms using modern technology.
[306] According to Rodriguez-Clare, knowledge spillovers could give rise to coordination failures even in absence of multiple equilibria, namely in case of spillover effects from the modern to the backward technology. Here, the adoption of the modern technology is no longer an equilibrium, but all agents would be better off if this technology would be adopted. Rodríguez-Clare, above n 184, at 7.
[307] The coordination failure concerning infrastructure projects might also be formulated in terms of economies of scale. Rodríguez-Clare, above n 184, at 6-8; Ray, above n 72, at 141.

of public goods, the role of the government would be to (permanently) invest in this unprofitable activity.[308]

In sum, in the presence of economies of scale, thick market effects, knowledge spillovers, or public goods, actions by different agents become complementary. As Rodriguez-Clare argues, these actions are often imperfectly tradable and thus somehow local in nature (e.g., nontradable inputs, skilled workers, knowledge, and public goods or infrastructure). Turning the focus from the country-wide level of big-push models[309] to coordination failures on the sector level, Rodriguez-Clare links this argument to the theory of clusters that emerge in case of industry-specific and local externalities ('Marshallian externalities').[310] In essence, the cluster theory points to the benefits of geographical proximity of related industries. From the angle of coordination failures, a cluster could be described as a collection of related industries and public or private agents which have the potential to reach a higher level of productivity through coordination.[311] More commonly, a 'cluster' alternatively refers to those related industries and agents that have already successfully coordinated ('clustered') their actions, resulting in higher productivity.[312] There are many examples of industries which have successfully clustered/coordinated without any government intervention (e.g., Silicon Valley) but instead emerged from high expectations of complementary actions or strategic action by an important agent.[313] Yet, if coordination among complementary agents fails, as is often the case in low-income countries, governments might have a legitimate role in spurring coordination/clustering.

2.4.2.2.2. Promoting clustering

Should the government promote those sectors with the highest clustering potential? As the benefits of clustering are often attributed to knowledge spillovers, should low-income

[308] See also above n 71.
[309] According to Glăvan, Jeffrey Sachs is the foremost advocate of such a big-push model. B. Glăvan, 'Coordination Economics, Poverty Traps, and the Market Process – A New Case for Industrial Policy?', 13:2 *The Independent Review* (Fall 2008), 225-243, at 227.
[310] See Rodríguez-Clare, above n 184, at 8.
[311] A cluster might thus also fail to coordinate. According to Rodriguez-Clare, this feature differentiates a cluster from the concept of agglomeration economies, which suggests that proximity necessarily leads to higher productivity. If a cluster succeeds in cooperation, it to some extent leads to agglomeration economies. Rodríguez-Clare, above n 184, at 10.
[312] Rodriguez-Clare also implicitly refers to 'clusters' or 'clustering' in this meaning. Hereby, clusters are related industries or agents which have realized agglomeration economies. See, for example, Rodríguez-Clare, above n 184, at 12, 20; A. Rodríguez-Clare, 'Clusters and Comparative Advantage: Implications for Industrial Policy', 82 *Journal of Development Economics* (2007), 43– 57; see also B. Glăvan, 'Coordination Failures, Cluster Theory, and Entrepreneurship: A Critical View', 11 *Quart J Austrian Econ* (2008), 43–59, at 47, 52.
[313] Rodriguez-Clare gives the example of Stanford University as a key player in the emergence of the information-technology cluster in Silicon Valley. Rodríguez-Clare, above n 184, at 10.

countries induce knowledge-intensive industries (often called 'advanced industry')?[314] Rodriguez-Clare firmly dismisses this option, mainly for two reasons. Firstly, knowledge intensity is not an intrinsic characteristic of an industry because the same product which is produced in an advanced, skilled-intensive way in developed countries can often also be produced on the basis of a backward, unskilled-intensive technology.[315] Hence, the same industry could generate clustering benefits in one place but not in another. Put otherwise, whether or not the benefits of clustering (e.g., knowledge spillovers) are reaped depends on the *way* the good is produced (i.e., the technology). Consequently, simply stimulating (via import substitution or export promotion tools) local production of goods that in developed countries are produced with an advanced technology might result in a local industry using a backward technology, with no clustering benefits attached to it.[316] Secondly, and somewhat more fundamental[317], if an industry generates strong clustering benefits, developed countries have probably already reaped these benefits, resulting in high productivity and a low international price of the product in question. This could in turn nullify potential benefits of clustering in low-income countries.[318] In the view of Rodriguez-Clare, what matters is thus not the level of an industry's clustering potential but 'plain old comparative advantage'.[319] Assuming all industries have some clustering potential[320], countries should induce clustering in those sectors in which they have *revealed* a natural or Ricardian comparative advantage (factor endowment), except if an industry outside a country's comparative advantage generates large economy-wide (i.e., inter-industry) externalities.[321] Therefore, industrial policy is not about *creating* comparative advantage, but about achieving higher productivity that flows from clustering in sectors in which a country has revealed or 'discovered' its comparative advantage. In the first stage of development, government policy should thus focus on inducing self-discovery, as along the lines developed by Hausmann and Rodrik (see

[314] Although different types of coordination failures are elaborated, Rodriguez-Clare puts most emphasis on those emerging from knowledge spillovers (see also below n 327).
[315] In this respect, Rodriguez-Clare draws a parallel with the 'product-cycle'-hypothesis.
[316] Citing Porters, Rodriguez-Clare indicates that what matters is not 'what you produce, but how'. Rodríguez-Clare, above n 312, at 44. Compare and contrast with below n 380.
[317] The first argument could be countered by linking support to the technology rather than to the sector. See also Rodrik, above n 161, at 109, 115.
[318] See above n 188.
[319] Rodríguez-Clare, above n 312, at 44.
[320] Rodríguez-Clare, above n 181, at 20.
[321] This is only valid if knowledge spills over inter-industry on a national and not on an international level (see above). Rodríguez-Clare, above n 312, at 55; Maloney and Rodríguez-Clare, above n 163, at 669. Nordås et al also hold that duplicating clustering has been successful only when it is built on local comparative advantage. H. K. Nordås, S. Miroudot, and P. Kowalski, 'Dynamic Gains from Trade', *OECD Trade Policy Working Papers* No 43 (2006), 53 pp., at 20.

above).[322] If, as a result, countries have 'discovered' their comparative advantage, policies promoting clustering in some of those sectors should be put in place.

But how should those sectors be selected?[323] First, strong export performance might already filter out sectors in which a country has discovered its comparative advantage. Yet, because many sectors would satisfy this export performance criterion and clustering support entails significant human and financial resources, a further selection should be made. Those sectors in which only a few firms operate are likely to overcome coordination failures without government intervention and would therefore drop out. In contrast, large sectors interacting closely with other sectors in the economy might be selected. Moreover, the chances of successful support are higher if offered to sectors clearly committed and organized, which could be revealed by a selection process whereby different private sector proposals are evaluated.[324]

Further, how should the few sectors resulting from such a selection process be supported? Overall, as the purpose is not to create comparative advantage, policies should not distort prices so as to reallocate resources to certain sectors (e.g., through 'hard' industrial policies such as import substitution or export promotion[325]).[326] Instead, Rodriguez-Clare calls for a 'soft' industrial policy that aims at inducing clustering, which depends on the particular coordination failure inhibiting (further) clustering. Assuming coordination failures resulting from knowledge spillovers attached to modern *technologies*, countries should induce innovation around these selected sectors ('innovation clusters') by providing R&D subsidies (e.g., tax breaks, fixed grants for innovative research, or collaborative research between the private sector and universities), infrastructure investments and/or regulatory reforms. Given that knowledge spillovers attenuate with geographic distance and are stronger for firms

[322] According to Rodriguez-Clare, the appropriate mix of both types of industrial policy depends on the level of development. In particular, he refers to findings by Imbs and Wacziarg revealing a U-shaped relationship between growth and diversification: countries first diversify and later on start specializing (above n 254). Hence, poor countries should induce self-discovery and more advanced countries should induce specialization. However, Imbs and Wacziarg show that countries start specializing relatively late in their development process and specialization of *exports* even kicks in at a much later stage, suggesting that only high income countries would benefit from concentrating their production/exports. Note that Rodriguez-Clare's own example of Costa Rica as a candidate for clustering would in fact still be in the phase of self-discovery. The World Bank study seems to approach both types of interventions in a complementary rather than sequential way (below n 338). Rodrik, above n 161, at 114; Rodríguez-Clare, above n 181, at 23-24; Imbs and Wacziarg, above n 254, at 69; Brenton, Newfarmer, Shaw, and Walkenhorts, above n 254, at 3-4; Hesse, above n 254, at 58.

[323] According to Rodriguez-Clare, only a limited number of clusters should be selected. This somewhat differs from Porter's view, who holds that all existing and emerging clusters deserve attention. On Porter's view, see P. Desrochers, F. Sautet, 'Cluster-Based Economic Strategy, Facilitation Policy and the Market Process', 17:2/3 *The Review of Austrian Economics* (2004), 233–245, at 236; Glăvan, above n 312, at 49.

[324] Rodríguez-Clare, above n 181, at 29.

[325] Yet, a soft type of export promotion is considered legitimate (e.g., subsidies for the exploration of foreign markets or a country's marketing abroad). Rodríguez-Clare, above n 181, at 10-11.

[326] They should therefore not create clustering from scratch. Rodríguez-Clare, above n 312, at 52.

engaged in similar or related activities, such selective support would be more effective than stimulating innovation across the board or in knowledge-intensive *industries* (high-tech goods) in which they do not have a comparative advantage.[327] In addition, complementary investments in infrastructure and regulatory reforms could be undertaken related to the selected sectors.[328] Such 'soft policies' focusing on a set of selected sectors in which a country has a comparative advantage are likely to be more transparent and less costly than the 'hard policies' (e.g., export processing zones[329]) as those undertaken in Latin American countries in previous decades .[330] These types of micro-economic (or competiveness) policies should complement macroeconomic and institutional reforms.[331]

This theory of clustering, originated in the work of Porter,[332] has attracted significant attention from national governments as well from international organizations (e.g., OECD, World Bank, UNCTAD) in recent years.[333] Still, some criticism on its theoretical foundations as well as its practical relevance is emerging.[334] For instance, clustering entails the risk of collusion and congestion and the question is raised whether it is conductive for long-term economic development as reliance on a particular sector makes regions vulnerable (portfolio argument).[335] Further, as clusters' geographic boundaries are vague, empirical evidence on the benefits of clustering is hard to advance and translating the cluster theory into concrete policy advice seems difficult given the heterogeneity of clusters.[336] As many actions of

[327] Overall, Rodriguez-Clare seems to emphasize the importance of inducing 'innovative clusters'. To be precise, the advice for developing countries is not to bring R&D spending up to the level of knowledge-intensive countries (see above 199). Instead, even when they are not knowledge-intensive, developing countries should induce innovation in some sectors in their comparative advantage, if it is not producing these goods at the global technological frontier (i.e., the level of R&D spending in those sector is relatively low) ('innovation shortfalls') due to a lack of knowledge accumulation caused, for example, by inadequate internalization of knowledge spillovers. Rodríguez-Clare, above n 312, at 52; Maloney and Rodríguez-Clare, above n 163, at 683.

[328] Rodríguez-Clare, above n 181, at 24. According to Rodriguez-Clare, both are necessarily selective in nature. Hence, Rodriguez-Clare's proposal does not seem to avoid picking (revealed) winners.

[329] Notice that Rodriguez-Clare rejects the installation of export processing zones, while most authors consider these as examples of clusters. See, for example, Pack and Saggi, above n 211, at 285, 286.

[330] According to Rodriguez-Clare, many of these 'hard policies' (e.g., export processing zones) should also be removed because of WTO obligations. Rodríguez-Clare, above n 181, at 29. However, this view seems overly restrictive (see below).

[331] Rodríguez-Clare, above n 181, at 5.

[332] In fact, the theory's origins can be traced back to the 1960s, with some of its elements even up to the end of the 19th century (Marshall). Y. Motoyama, 'What Was New About the Cluster Theory?: What Could It Answer and What It Not Answer?', 22:4 *Economic Development Quarterly* (2008), 353-363, at 354-355.

[333] Glăvan, above n 312, at 48. Nonetheless, the World Development Report 2005 also lists downsides of fostering clustering (see below n 336).

[334] See, for example, Glăvan, above n 312; Glăvan, above n 309; Desrochers and Sautet, above n 323, at 233–245.

[335] Hence, it should be taken care of that at least some different clusters are stimulated in one region.

[336] See, for example, World Development Report 2005, above n 253, at 166.

agents are complementary, the question on which set of actions has to be supported is hard to decide on.[337]

Rodriguez-Clare's suggestion to target existing exporters seems to correspond with the 2009 World Bank study policy recommendation to not only devote attention to the 'discovery' phase, but equally to the 'rapid-growth' or acceleration phase of exports.[338] Next to 'product diversification',[339] 'geographical' diversification equally seems to be positively correlated with growth: high-income countries tend to be more successful in penetrating the available markets for their products. Conversely, low-income countries only take advantage of a small portion of potential *new* markets.[340] Brenton and Newfarmer list several potential market failures that might justify government intervention to spur this rapid-growth phase (e.g., factor market imperfections, for example in the capital market, information asymmetries on new export markets, imperfections in domestic services or infrastructure).[341] What is more, because of their important share in total export growth, an export promotion strategy should not ignore the potential expansion of existing products to *old* markets (by productivity improvements). In sum, the World Bank advocates a very comprehensive export promoting strategy for low-income countries which pays attention to potential *new* export products, *new* markets as well as *old* markets. Emphasizing that 'policy can make a difference', the World Bank study suggests that, though 'there is no magic receipt to promote diversification', 'a broad array of policies, ranging from getting the incentive structure right, to lowering the cost of trade-related services, to proactive policies', can be on the agenda.[342]

At first sight, this World Bank's current vision seems to fit well with the argument expressed by leading author Rodrik. Starting from the observation that 'no one size fits all', Rodrik acknowledges that market-friendly policies, prioritizing economic growth, and maintenance of macro economic stability are 'the sine qua non of economic growth'. The World Bank equally agrees that 'something more', namely industrial policies in the meaning of functional

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337 With respect to Rodriguez-Clare's proposal to spur clustering of *existing* exporters because of coordination failures, two questions might be raised. First, existing exporters might be those that have succeeded to overcome coordination failures by themselves and thus might not need government intervention to this end (see along these lines, Rodriguez' comment on Rodríguez-Clare, above n 184, at 35-36). Second, potential exporters might exactly fail to start or sustain exports because of their failure to coordinate.

338 As indicated above, the World Bank seems not to agree with Rodriguez-Clare's sequencing proposal (above n 322) given that stimulating *existing* exporters (to old as well as to new markets) should equally form part of the development strategy used by low-income countries.

339 This only holds true up to certain level of income.

340 Indeed, their exports reached only 6.5 per cent of nations importing the same product, whereas fast growing countries reached some 26 per cent of nations importing the products they produce. As mentioned above, geographic diversification could also reduce the vulnerability for third country shocks.

341 Cost of gathering information on export opportunities to new markets might be relatively high as not many other firms export to that country compared to firms from other countries.

342 Brenton, Newfarmer, Shaw, and Walkenhorts, above n 254, at 1-35.

ánd selective policy interventions, is in most instances needed to overcome market failures so as to initiate structural change in low-income countries.

Yet, a fundamental divergence remains present between both these perspectives, which hinges on the importance attached to trade (and FDI) as driver(s) of economic growth. Indeed, this section has illustrated that both stances agree subsidies to exporters might be useful instruments for correcting market failures, but a careful reader might have identified how the World Bank's plea was in addition underpinned by another argument, namely that exports (and export diversification) are an engine of economic growth. This is further clarified in the next section.

2.4.3. Trade and economic growth

A pivotal but unsettled question is to what extent trade openness spurs economic growth. In examining this relationship, one should look beyond the static effects of trade, as these only generate one-time benefits, and address the dynamic effect of trade on technological progress, given that such progress is the dominant factor explaining sustained economic growth (increasing total factor productivity).[343] From both empirical and theoretical perspectives, opposite views are expressed on whether trade contributes to long-term economic growth.[344] On the empirical side, most economists have found that trade openness is beneficial for economic growth, although Rodriguez and Rodrik have criticized this empirical evidence on the basis of methodological shortcomings.[345] An OECD study concluded that 'there is robust evidence of a link between productivity levels and trade as measured by (exports + imports)/GDP, but a causal and robust link between trade liberalization, as measured by changes in tariff restrictions or non-tariff barriers, and productivity growth is yet to be established'.[346]

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[343] Indeed, the static gains of trade (e.g., specialization) cannot explain long-term patterns of economic growth as these only generate one-time gains in GDP growth at the moment a country opens to trade (more efficient allocation of resources). As the endogenous growth literature indicates, long-term economic growth is explained mainly by technological change. Hence, the endogenous growth theory looks at factors (such as trade) which can explain the change in technological improvements. World Trade Report 2008, above n 125, at 65; Nordås, Miroudot, and Kowalski, above n 321.

[344] D. Acemoglu, *Introduction to Modern Economic Growth* (New Jersey: Princeton University Press, 2009), 1008 pp., at 678-679.

[345] Tracing the causal relationship is a recurring difficulty in regression studies. Acemoglu, above n 344, at 678-679; F. Rodríguez and D. Rodrik, 'Trade Policy and Economic Growth: A Skeptic's guide to the Cross-national Evidence', *Working Paper* (May, 2000), 73 pp.; OECD, *Trading Out of Poverty – How aid for trade can help* (Paris: OECD, 2009), 38 pp., at 13-14; J. E. Stiglitz and A. Charlton, *Fair Trade For All – How Trade Can Promote Development* (Oxford: Oxford University Press, 2005), 315 pp., at 33-35. Still, the 2008 World Trade Report concluded that 'while the conclusions of the macro economic evidence have been questioned recently, the evidence on knowledge spillovers and firm productivity provides a more clear-cut (even if indirect) answer about the positive effect of international trade and growth'. World Trade Report 2008, above n 125, at 71.

[346] Nordås, Miroudot, and Kowalski, above n 321, at 15. Recent research of Freund and Bolaky has revealed that trade openness spurs economic growth in flexible economies but not in rigid economies,

2.4.3.1. Theoretical arguments on trade opening: Reversing comparative advantage through trade instruments?

Theoretical arguments also point to different directions. On the downward side, the static benefits of opening up to trade that result from efficient resource allocation through specialization might come at the cost of dynamic gains of trade in case of difference in learning-by-doing potential between sectors.[347] From a static welfare perspective, developing countries' gains of opening up to trade result from specialization according to existing patterns of comparative advantage (often low-tech sectors featuring low levels of productivity growth) and no case could be made for policy intervention. However, from a dynamic welfare perspective, such specialization in the low-tech sector might imply that developing countries forgo the high potential of learning-by-doing in the high-tech sector.[348] Recalling the Lincoln-example elaborated above, by specializing in the low-tech clothing sector (characterized by low learning-by-doing potential and low productivity growth), China foregoes the potential to learn-by-doing in the high-tech computer sector. In fact, this model underpins the infant industry argument related to dynamic economies of scale. Yet, it should not be overlooked that importing countries (like China) can nonetheless benefit from learning-by-doing in the high-tech sector in the exporting country through its effect on the terms of trade. Indeed, an increase in productivity in an exporting sector creates a negative terms of trade effect against the exporting country (and other exporting countries) but a positive terms of trade effect for importing countries. As such, China would also indirectly benefit form the productivity improvement in the US computer sector through a positive terms of trade effect (lower price of computers in terms cloths), which would temper or even neutralize the dynamic loss of specializing in the 'wrong' low-growth sector.[349] Nonetheless, Redding shows that in case a developing country has a large potential for learning-by-doing (productivity growth) in the high-tech sector relative to its trading partners, welfare could certainly be improved by temporary subsidization of the high-tech sector so as to reverse the

hereby suggests that flexible trade regulation on firm entry is important for trade opening to have an impact on resource reallocation. Hence, improvement of the business climate might have to be undertaken before (or together with) trade opening in rigid economies. C. Freund and B. Bolaky, 'Trade, Regulations, and Income', 87 *Journal of Development Economics* (2008), 309–321.

[347] See, for example, World Trade Report 2008, above n 125, at 68.

[348] Yet, the country gains from (the low) learning-by-doing in the low-tech sector because trade expands the market for their low-tech goods (scale effect). Hence, trade not only has a direct effect on resource allocation (static) but such reallocation also affects the learning-by-doing and productivity growth over time (dynamic effect).

[349] The exact effect on the terms of trade depends *inter alia* on the elasticity of demand. If demand for computers would be highly inelastic, productivity improvements in the US computer sector could even hurt the US because of a sharp decline in its terms of trade (this phenomenon is called immiserizing growth). Jagdish Bhagwati, 'Immiserizing Growth: A Geometrical Note' 25:3 *The Review of Economic Studies* (June, 1958), at 201-205; World Trade Report 2003, above n 216, at 102.

pattern of specialization.[350] Hence, an argument could be made for temporal subsidization in sectors in which a developing country currently lacks a static comparative advantage but exhibits a large potential for productivity growth relative to its trading partner (dynamic comparative advantage).[351] Moreover, even world welfare would be boosted by inducing a more efficient allocation of resources as the higher potential of productivity growth in the high-tech sector could pay off.[352] Concretely, countries with high levels of human capital, which could achieve high rates of productivity growth through imitation, are presented as examples where a case for intervention could be made.[353] Further, any indirect effect through the terms of trade could also not substitute for producing the high-tech good itself in case learning-by-doing in that sector not only raises productivity in the sector itself (affecting their price and thus terms of trade) but also affects the productivity of related industries or the entire economy.[354] Indeed, the potential benefit for China in producing computers not only lays in the high-growth potential of the computer sector (which could potentially be 'tapped' off from abroad through the terms of trade) but is equally situated in the generated knowledge that spills over to other sectors of the economy. This conforms to the observation made above, detailing how countries are interested in those sectors which generate local knowledge spillovers (*external* economies of scale). For example, Succar has formally shown that subsidization of infant industries is required in case of intra- or inter-industry spillovers and that this would make the economy better off than being an importer.[355] Greenwald and Stiglitz also make a case for infant industry protection (i.e., imposing a uniform tariff) for the industrial sector because innovation in the domestic industrial sector would generate positive spillovers for the agricultural sector.[356]

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[350] S. Redding, 'Dynamic Comparative Advantage and the Welfare Effects of Trade', 51 *Oxford Economic Papers* (1999), 15-39.

[351] Similarly, a country could have a static comparative advantage because of a head start which enabled it to reap external economies of scale and thus to capture the industry in question, even though the newcomer would potentially be more efficient if it would be allowed (by protection and/or promotion) to equally reap such economies of scale. Krugman and Obstfeld, above n 104, at 150-152.

[352] To be sure, foreign targeting of the high-tech sector (e.g., computer sector) depresses the terms of trade of net-exporting countries of computers (US) (see above n 68).

[353] S. Redding, 'Dynamic Comparative Advantage and the Welfare Effects of Trade', 51 *Oxford Economic Papers* (1999), 15-39, at 35-39.

[354] This is the definition of learning-by-doing externalities given in the 2008 World Trade Report. World Trade Report 2008, above n 125, at 68.

[355] The subsidy would be higher in case learning-by-doing not occurs only intra-industry but also inter-industry. Such inter-industry benefits could even legitimize subsidies to industries turning out inefficient after learning-by-doing, if total benefits outweigh total costs of the subsidy. In case it only generates intra-industry spillovers, subsidizing such inefficient industry is not legitimate as the cost of the subsidy is by definition larger than its benefits. Succar, above n 206, at 533. Succar does not consider terms of trade effects (i.e., two small countries model).

[356] Their model assumes that the industrial sector is the source of innovation and that spillovers are concentrated within borders. To be precise, the model allows for (and would even be strengthened in case of) international knowledge spillovers within the *industrial* sector insofar as transmission increases with the size of the domestic industrial sector. The tariff would be self-limiting as successful local producers would start exporting and be in favour of liberalization. B. Greenwald and J. E.

In contrast to these negative theoretical predictions, other arguments integrate the potential of international knowledge spillovers. Indeed, in the previous models learning-by-doing only affects the productivity of sector(s) within a country, hereby implying that specialization in the wrong sector is quasi-permanent unless the government intervenes (by subsidies or tariffs) so as to alter the pattern of specialization. However, patterns of specialization might change over time even if a country is open to trade and trade itself could facilitate this process as it generates *international* knowledge spillovers, implying that foreign learning-by-doing could also affect the productivity of (both) sectors in the developing country and thus its growth rate.[357] If the fundamentals of comparative advantage are altered (e.g., through capital accumulation or investment in human capital), developing countries could still 'capture' the high-tech sector in case previous foreign learning-by-doing ('learning-by-imitation') is available, which is more likely if trade is open.[358] In general, theoretical arguments predicting a positive growth effect of trade opening point to the productivity improvements resulting from importation and exportation. Next to a competition effect, the presence of international knowledge spillovers could hereby be seen as 'crucial for the realization of the dynamic gains from trade'.[359]

First, imports, especially those of high-tech products, would generate knowledge spillovers to the importing country and thus boost its total factor productivity.[360] For example, firms in East Asian countries have strengthened their technological capabilities by 'reverse-engineering' of capital imports.[361] Second, a robust finding in empirical studies documents

Stiglitz, 'Helping Infant Economies Grow: Foundations of Trade Policies for Developing Countries', *AEA Papers and Proceedings* (May, 2006), 141-146. Yet, the model fails to acknowledge that imposing trade barriers might precisely cut the domestic industry off from such international knowledge spillovers.

[357] World Trade Report 2008, above n 125, at 68 and 72; Nordås, Miroudot, and Kowalski, above n 321, at 19.

[358] Trade opening increases the flows of information. An increase in human capital not simply translates into higher productivity but also facilitates the adoption of new technologies and thus the diffusion of technology. Acemoglu, above n 344, at 618.

[359] World Trade Report 2008, above n 125, at 72. Hence, one can identify a tension between the theory of clustering, which requires proximity (e.g., *local* knowledge spillovers), and theoretical arguments suggesting dynamic benefits of trade, which depend on the presence of *international* spillovers. See also Nordås, Miroudot, and Kowalski, above n 321, at 21.

[360] Such spillovers would be higher if a country imports relatively more from high income countries. World Trade Report 2008, above n 125, at 72; Nordås, Miroudot, and Kowalski, above n 321. Next to knowledge spillovers, imports could also generate extra competitive pressure on import-competing industries (competition effect) and hereby induce innovation and thus productivity improvements. On the other hand, Shumpeter has argued that innovation requires some monopoly rents and increased competition might thus also lower incentives to innovate. Theoretical arguments on the link between competition and innovation are therefore mixed and the ultimate result thus rests on empirical evidence. For example, Lawrence and Weinstein have found that competitive pressure and potential learning from foreign rivals were important sources of growth explaining the economic success in Japan and Korea. Lawrence and Weinstein, above n 243; World Trade Report 2008, above n 125, at 69; OECD, *Trading Out of Poverty – How Aid for Trade Can Help* (Paris: OECD, 2009), 38 pp., at 10-11.

[361] Brahmbhatt and Hu, above n 200, at 6.

that exporting firms are more productive than non-exporting firms.[362] We focus more closely on the positive effects of exports in the next paragraph.

2.4.3.2. The role of exports in spurring economic growth

Largely, the relatively higher productivity of exporting firms is explained on the basis of self-selection: more productive firms choose to start exporting. Yet, some studies have also found that firms become more productive because of the process of exportation (learning-by-exporting) as they succeed in absorbing foreign knowledge.[363] This would imply that the observed correlation between exports and economic growth at least partly runs from the former to the latter.

Hence, two reasons for subsidizing exports should be distinguished. First, the simple but robust evidence that exporting firms are more productive (even if this is so due to the self-selection effect) supports the argument to link subsidization to export performance (carrot-and-stick argument), certainly because market failures are often considered relatively more prevalent in the exporting sector. It is generally accepted that the East Asian countries successfully imposed exportation as a performance criterion.[364] This carrot-and-stick argument, combined with the high prevalence of market failures in the tradable sector, also explains why authors such as Rodrik, who rejects the learning-by-exporting argument and generally doubts that trade openness is conductive for economic growth, are nonetheless in favor of export subsidies so as to overcome market failures related to discovery or clustering.

Second, the theoretical argument of and empirical evidence on learning-by-exportation effects, often combined with the assumption that such learning spills over to other segments of the economy (and thus generates a real spillover)[365], offers another justification for subsidizing exports.[366] The fact that these spillovers are considered more prominent in

[362] World Trade Report 2008, above n 125, at 138

[363] For an overview of the mixed evidence, see World Trade Report 2008, above n 125, at 138-139; W. Keller, 'Transfer of Technology', in S. N. Durlauf and L. Blume (eds), *New Palgrave Dictionary of Economics – Volume 8*, 2nd ed (London: Palgrave Macmillan, 2008), 367-371, at 367-371; Brahmbhatt and Hu, above n 200, at 10-13; B. Eichengreen, 'The Real Exchange Rate and Economic Growth', *Commission on Growth and Development – Working Paper* No. 4 (2008), 35 pp., at 17-19. On the export side as well, increased competition in exporting markets might induce innovation (see above n 360). Starting to export also generates a temporary boost in innovation through scale effects (inventing new inputs becomes more profitable). Acemoglu, above n 324, at 680.

[364] See, for example, World Bank, Global Economic Prospects 2008, above n 253, at 145.

[365] *An sich*, the learning-by-exporting evidence does not justify government intervention: under perfect market conditions, firms would grasp the opportunities of exporting if this brings productivity gains. Therefore, the evidence is often combined with the assumption that such learning spills over. Alternatively, it would justify a focus on other market failures (e.g., capital market failures, labor market failures) which inhibit exportation or export diversification. Hence, such support should not always take the form of an export subsidy, i.e., a subsidy contingent upon exportation (see also below on the definition of export contingency; Part II, Chapter 4, Section 4.1.1).

[366] This might explain why the World Bank also emphasizes the importance of spurring existing exports.

manufacturing than in agriculture is one of the theoretical arguments explaining why export *diversification* is seen as conductive for economic growth.[367] Hence, empirical evidence on the link between exports (and export diversification) and economic growth combined with theoretical arguments and empirical evidence suggesting that causality at least partly runs from exportation (diversification) to growth would offer a supplementary argument for policy interventions affecting exportation. Indeed, this exactly underpins the World Bank's plea for proactive policies to support trade and export (diversification) in particular.[368] In this respect, the 2009 World Bank study on export diversification acknowledged that 'laissez-faire policies combined with low tariffs are rarely sufficient to prompt dynamic export drives or overcome obstacles in other areas'.[369] Hence, opening up to trade and its generating of *inter alia* channels through which international spillovers become available is seen as conductive for economic growth but insufficient to bring structural change because of the presence of market failures.[370] Observing that a flourishing export sector is a critical ingredient of high growth, especially in the early stages, the 2008 Report of the Growth Commission analogously stressed that 'if an economy is failing to diversify its exports and failing to generate productive jobs in new industries, governments do look for ways to try to jump-start the process, and they should'.[371] Therefore, developing countries 'may also need some latitude to promote their exports until their economies have matured and their competitive position has improved'.[372] Such export-led or outward-looking strategy does not imply that the benefits generated through imports are overlooked. To the contrary, according to the Growth Report the purpose of higher exports is not to increase reserves or build up a trade surplus (as would

[367] Brenton, Newfarmer, Shaw, and Walkenhorts, above n 254, at 7.
[368] For example, Brenton et al conclude that 'there is enough evidence on the relationship between diversification of exports, exports growth, and economic growth to support developing countries, especially low-income countries, in implementing an explicit policy of diversifying exports'. Moreover, 'the significant productivity enhancements from exporting argue for government interventions to subsidize some export activities, and many governments in both developing and high-income countries have set up export promotion agencies'. Brenton, Newfarmer, Shaw, and Walkenhorts, above n 254, at 22, 25.
[369] Brenton, Newfarmer, Shaw, and Walkenhorts, above n 254, at 27-28.
[370] Hence, a double motivation seems to underpin the World Bank's plea for targeting export (diversification): (i) it spurs economic growth (see n 368), which is in itself partly explained on the basis of knowledge spillovers (and is thus related to a market failure); (ii) it is hampered by market failures.
[371] Such support should be temporary, quickly evaluated and remain as neutral as possible about those exports to be supported (though this is not a rigid rule). With regard to selective government interventions, the Growth Report at the same time observed that these policies are still highly controversial and '(w)ithin the Commission and the broader policy community, there is a wide range of opinion about their benefits and risks'. Commission on Growth and Development, above n 149, at 7, 48, 49.
[372] Commission on Growth and Development, above n 149, at 11. The classic version of 'export-led growth' is premised on rapid growth in imports of inputs and capital. Yet, the neo-mercantilist version features a lagging of import growth behind exports and hence a growing trade surplus. W. R. Cline, 'Exports of Manufactures and Economic Growth: The Fallacy of Composition Revisited', *Commission on Growth and Development – Working Paper* No. 36 (2008), 38 pp., at 32.

be the case under a mercantilist vision on trade), but to generate higher levels of export learning as well as to enable higher levels of imports embodying new knowledge.[373] Along the same lines, the 2009 Annual Report by the WTO Director-General underlined that the export-led strategy followed by emerging Asian countries have 'in large measure been remarkably successful in spurring economic growth'.[374] Yet, given the drop in foreign demand caused by the economic crisis of 2008-2010, rebalancing towards domestic demand is urged for, not only to reduce global trade imbalances but also to serve those countries' own interest (see below Section 2.5).[375]

Rodrik adequately summarizes the differing arguments underpinning the case for subsidizing exports:

> For export quantities to matter over the longer run, one must believe either in learning or other spillovers from exports, which have been hard to document, or in the story I laid out above, in which tradables are special because that is where the higher productivity activities are. The two accounts differ on the importance they attach to the act of exporting per se. The 'spillovers-from-exporting' story relies on the technological or marketing externalities that are created when a tradable good crosses an international boundary. The 'tradables-are-special' story is indifferent to whether international trade actually takes place or not.[376]

As this quote indicates, Rodrik adheres to the 'tradables-are-special' story because these activities are characterized by higher productivity than the non-tradable sector and he emphasizes that tradable goods are likely to suffer relatively more than non-tradables from institutional and market failures (e.g., those related to discovery, coordination failures, capital market failures).[377] High growth is achieved by a successful transformation from traditional (agricultural) towards more productive activities (industrial sector).[378] Next to sustaining macro economic stability, 'productivist policies' stimulating the transformation towards such 'tradables' should be employed, which all have in common that they act as subsidies on tradables. Although Rodrik thus holds a fundamentally different view on the importance of

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[373] Commission on Growth and Development, above n 149, at 51; Cline, above n 372, at 32.

[374] WTO, Trade Policy Review Body, Annual Report by the Director-General, *Overview of Developments in the International Trading Environment – Part B: Shaping factors for trade: looking into the future* (WT/TPR/OV/12, 18 November 2009), 39 pp., at paras 7-8 and 65-66.

[375] This could be done by channelling corporate profits to households through the tax system, by developing social safety nets, by improving the domestic investment climate and financial system, by altering the structure of output towards domestic demand (e.g., undoing the bias against services), or by giving those countries a greater voice in international financial affairs so that they become less dependent on accumulating foreign exchange reserves. WTO, Annual Report by the Director-General, above n 374, at paras 65-66.

[376] Rodrik, above n 242, at 15.

[377] See D. Rodrik, 'The Real Exchange Rate and Economic Growth', *Working Paper* (October, 2008), 35 pp; Rodrik, above n 242, at 19.

[378] However, Rodrik acknowledges that there are also modern activities in agriculture (e.g., horticulture) and services (e.g., call centers).

trade in the growth process[379], both 'spillovers-from-exporting' (endorsed, for example, by the World Bank) and 'tradables-are-special' (endorsed by Rodrik) arguments would suggest that industrial policies, targeting the exporting sector and consisting of functional as well as selective interventions, should be on the agenda of developing countries.[380]

One of these functional interventions acting as a subsidy on exports could be an exchange rate regime that results in an undervalued currency.[381] Rodrik argues that undervaluation facilitates growth and the Growth Commission Report, though expressing mixed opinions, overall also seems to suggest that it could be a useful instrument in the early stage of development.[382] Such an undervalued currency, which acts as both an across-the-board subsidy on exports and a tax on imports, is less vulnerable for being captured by private interests than selective interventions.[383] Yet, a downside in Rodrik's view is that it fails to distinguish between traditional export sectors (which do not deserve subsidization) and more productive sectors.[384] As analyzed in the Growth Commission Report, another disadvantage accompanying an undervalued currency is that it generates a trade surplus by encouraging exportation and discouraging importation.[385] As such trade surplus is mirrored by a trade deficit abroad, an undervalued currency indeed comes at the expense of other countries.[386] If

[379] 'What matters for growth is the ability to expand industrial economic activities, not trade per se. Industrial activity can increase without increasing trade, if domestic demand rises alongside'. His different view on trade could also be revealed from his differing stance on the relevance of imports. According to Rodrik, an increase in world trade might be a mixed blessing for developing countries: 'imports are dominated by industrial products, as is the case in many developing countries, a large expansion of trade can even be bad for domestic industrial output'. In parallel, Rodrik expresses doubts on the benefits of improvements in trade facilitation because this not only helps export activities but also takes protection away from import-substitution activities. Hence, Aid for Trade would not necessarily present a win-win situation in Rodrik's view. Here, Rodrik also seems to be more open to implement an export-promoting strategy together with only gradually liberalizing import barriers. Rodrik, above n 242, at 16; see also D. Rodrik, 'Second-best Institutions', *NBER Working Paper Series* No. 14050 (June, 2008), 12 pp., at 7-8.

[380] Rodrik also seems to support a more aggressive type of industrial policy which stimulates activities that might be further away from a country's current comparative advantage. See, for example, Rodrik, above n 270. Rodrik holds that what matters is not so much *how*, but *what* you produce as a country. See also Hausmann, Hwang, and Rodrik, above n 255, at 1-25. Yet, other authors have challenged this latter paper. For a discussion, see Brenton, Newfarmer, Shaw, and Walkenhorts, above n 254, at 8-9.

[381] Policy tools to affect the real exchange rate are listed in Rodrik, above n 377.

[382] Rodrik refers not only to China but also to India, Uganda and Tanzania. See also D. Rodrik, 'Industrial development: Some Stylized Facts and Policy Directions', in United Nations - Department of Economic and Social Affairs, *Industrial Development for the 21st Century: Sustainable Development Perspectives* (New York: United Nations, 2007), 7-28; A. Mattoo and A. Subramanian, 'Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade, Organization', *Peterson Institute for International Economics - Working Paper Series* (January 2008), 31 pp., at 12. For a more skeptical stance, see Eichengreen, above n 363. Aizenman and Lee find mixed results on whether a slightly undervalued exchange rate is an appropriate instrument to internalize learning-by-doing externalities. J. Aizenman and J. Lee, 'The Real Exchange Rate, Mercantilism and the Learning by Doing Externality', *NBER Working Paper Series* No. 13853 (March, 2008), 16 pp.

[383] It could consist of a devaluation or a suppression of an appreciation.

[384] Also, it fails to distinguish between first-movers and copycats (see above on discovery).

[385] See also Cline, above n 372, at 32-35.

[386] See also, O. Blanchard and G. M. Milesi-Ferretti, 'Global Imbalances: In Midstream?', *IMF Staff Position Note* (22 December 2009), 31 pp.

the initiating country has a substantive share in world trade, other countries might be tempted to act likewise, and thus inflict 'competitive devaluations' (as happened in the 1930s), or take recourse to other types of protectionist measures to restore their current account, making all countries worse off in the end. Therefore, Rodrik shows that selective subsidization of 'tradables' is a better option as it does not generate a trade surplus in the long run.[387] On this basis, Rodrik criticizes the SCM Agreement for being the main external obstacle for *larger* developing countries to employ such optimal industrial policies as it prohibits export subsidies and makes other subsidies 'actionable' under certain conditions, while at the same time leaving undervalued currencies untouched. In particular, he concludes that:

> In a world where economic growth requires the encouragement of modern economic activities in developing nations, the Agreement on Subsidies makes little economic sense. It rules out a desirable second-best policy for promoting economic diversification and structural change. It has the unintended consequence of inducing governments to favor an inferior policy (in view of its spillovers into trade imbalances), namely undervalued currencies. Worse still, it may encourage trade protection as a defensive measure against industrial imports. If we want greater international oversight on currency practices, as I think we should, we will need to substantially relax discipline over industrial subsidies.[388]

Following an in-depth legal analysis of the disciplines on different types of subsidies imposed on developing countries, we return to this criticism on the SCM Agreement in Part IV.[389]

2.4.4. Foreign direct investment and economic growth

Next to exports, foreign direct investment (FDI) is what Rodrik labels the other 'fetish' of the Washington Consensus.[390] Indeed, one of the Washington Consensus assumptions was that FDI is conductive for development and should thus be attracted, although the East Asian success stories widely differed in their openness to FDI.[391] In order to attract FDI, many developing countries have put an investment promotion regime in place, covering (i) information sharing, often conducted by investment promotion agencies (IPA), (ii) upgraded

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[387] The trade surplus generated by subsidizing tradables is undone by an appreciation of the real exchange rate as this, in turn, spurs consumption of 'tradables'. Yet, the effect of the subsidy is not undone because the appreciation needed to bring the trade balance back to zero is (proportionally) less than the magnitude of the subsidy as it affects both production and consumption margins. Rodrik, above n 242, at 19-20.

[388] Rodrik, above n 242, at 23.

[389] See also Rodrik, above n 251. See below Part IV, Chapter 3, Section 3.2.3.

[390] According to Rodrik, 'one dollar of FDI is worth no more (and no less) than a dollar of any other investment'. Rodrik as cited in T. H. Moran, E. M. Graham, and M. Blomström, 'Introduction and Overview', in T. H. Moran, E. M. Graham, and M. Blomström (eds), *Does Foreign Direct Investment Promote Development?* (Washington DC: Institute for International Economics, 2005), 1-19, at 2.

[391] For example, Korea has been restrictive to FDI and instead emphasized licensing of foreign technology and building of local capabilities, while Singapore was much more open to FDI. Brahmbhatt and Hu, above n 200, at 14; Moran, Graham, and Blomström, above n 390, at 2.

infrastructure, mostly located in special economic zones, and (iii) fiscal incentives (e.g., tax credits) or financial incentives (e.g., direct subsidies).[392]

Now, on what basis is such government intervention generally legitimized?[393] By enlarging the stock of capital, FDI positively affects economic growth[394] but long-term benefits depend on the productivity improvements that are generated. FDI could have an impact on the host country's productivity in a threefold way. Foreign-investors might be more productive and thus increase industry-level productivity (compositional effect).[395] Next, they might generate extra competition with domestic firms and therefore affect their productivity (competition effect).[396] As often emphasized by policymakers, a third effect is the potential spilling over of increased knowledge channeled by foreign-investors to domestic firms in the same industry (intra-industry; horizontal spillovers) and/or to upstream industries (inter-industry; vertical spillovers). Such knowledge could, for example, be channeled by imitation through observation (e.g., technology itself or managerial/organizational innovations) or through labor movements or training.[397] Hence, governments have not only created incentives for attracting FDI in the first place but have also imposed measures to extract more knowledge from a given investment (e.g., local content requirements, licensing requirements).[398]

However, empirical evidence on productivity growth generated by FDI in developing countries has generated mixed results. With regard to the intra-industry level (*horizontal*

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[392] Harding and Javorcikr have found that investment promotion indeed leads to higher FDI inflows in developing countries. T. Harding and B. S. Javorcikr, 'Developing Economies and International Investors: Do Investment Promotion Agencies Bring Them Together?', *World Bank – Policy Research Working Paper* No 4339 (August, 2007), 50 pp. In 1998, more than 100 countries offered tax concessions to FDI. L. Alfaro and A. Rodriguez-Clare, 'Multinationals and Linkages: An Empirical Investigation', *Economia* (Spring, 2004), 113-169, at 114; T. H. Moran, E. M. Graham, and M. Blomström, 'Conclusions and Implications for FDI Policy in Developing Countries, New Methods of Research, and a Future Research Agenda', in T. H. Moran, E. M. Graham, and M. Blomström (eds), *Does Foreign Direct Investment Promote Development?* (Washington DC: Institute for International Economics, 2005), 375-395.

[393] The literature displays the same duality than the one discussed concerning exports and economic growth: some authors argue government intervention is legitimate if proven that FDI spurs economic growth, whereas others seem to stress that the presence of a market failure is also required. Still, the element that explains a potential positive impact on economic growth also points to a market failure, namely knowledge spillovers.

[394] This holds true unless capital is raised in the country. Employment is another argument often raised to justify FDI incentives is. See Alfaro and Rodriguez-Clare, above n 392, at 114; B. S. Javorcik, 'Can Survey Evidence Shed Light on Spillovers from Foreign Direct Investment?', 23:2 *The World Bank Research Observer* (Fall 2008), 139-159, at 139.

[395] For example, a study on Indonesian manufacturing has shown that firms become more productive after foreign acquisition. J. M. Arnold and B. S. Javorcik, 'Gifted Kids or Pushy Parents? Foreign Acquisitions and Plant Performance in Indonesia', *Centro Studi Luca D'Agliano Development Studies Working Papers* No 197 (March 2005), 35 pp.; Alfaro and Rodriguez-Clare, above n 392, at 116.

[396] J. Bitzer and H. Görg, 'Foreign Direct Investment, Competition and Industry Performance', 32:2 *The World Economy* (2009), 221-233, at 223.

[397] On a horizontal level, trained employees might for example move to domestic firms, while on a vertical level foreign firms might offer training to employees of their local suppliers. Next to knowledge spillovers, FDI might also generate 'demonstration effects' to other potential investors or acquire reputation in foreign markets, benefiting other domestic firms.

[398] Commission on Growth and Development, above n 149, at 42.

effect), ambiguous and sometimes even negative productivity effects have been found. Here, arguments related to all three channels have been advanced to explain these results. First, the assumption that foreign-investors are more productive might not always hold, especially when FDI takes the form of mergers and acquisitions.[399] Second, the competition effect might also work negatively if FDI induces domestic firms to cut production back to an inefficient scale.[400] Third, foreign-investors might be particularly keen to minimize knowledge leakages to domestic competitors and domestic firms might be unable to learn-by-imitation if they do not have the capacity to absorb potential spillover. The latter occurs in case of low levels of human capital and a wide technological gap between foreign and domestic firms.[401] Differences in levels of absorptive ability would also explain why horizontal spillover effects are stronger in developed than in developing countries.[402]

On the other hand, empirical evidence on positive productivity effects of FDI on suppliers in developing countries is more promising (*vertical* effect).[403] This might not come as a surprise given that foreign investors have a direct interest in improving the productivity of upstream suppliers.[404] The presence of vertical knowledge spillovers is indeed well documented, whereby its degree depends again on the local conditions of the host country and suppliers (e.g., R&D level, human capital level, financial market development).[405]

Overall, 'the jury is still out on whether or not inward FDI generally is conductive to domestic productivity growth'.[406] The existence of vertical knowledge spillovers might offer some

[399] L. Colen, M. Maertens, and J. Swinnen, 'Foreign Direct Investment as an Engine for Economic Growth and Human Development: A Review of the Arguments and Empirical Evidence', *Leuven Centre for Global Governance, Working Paper No. 16* (September, 2008), 48 pp.

[400] Hence, this assumes economies of scale. J. Konings, 'The Effects of Foreign Direct Investments on Domestic Firms – Evidence from Firm-level Panel Data in Emerging Economies', 9:3 *Economics of Transition* (2001), 619-633.

[401] Alfaro et al also point to the importance of developed financial markets. L. Alfaro, S. Kalemli-Ozcan, and S. Sayek, 'FDI, Productivity and Financial Development', *The World Economy* (2009), 111-135.

[402] Brahmbhatt and Hu, above n 200, at 16. Mayer-Foulkes and Nunnenkamp have also indicated that developing countries often lack the absorptive capacity to benefit from FDI. Local firms are often too much behind the technological frontier to learn by imitation. They have found that US FDI contributes to convergence only for high-income countries but could lead to divergence for many middle- and low income countries. D. Mayer-Foulkes and P. Nunnenkamp, 'Do Multinational Enterprises Contribute to Convergence or Divergence? A Disaggregated Analysis of US FDI', 13:2 *Review of Development Economics* (2009), 304–318.

[403] Spillovers to downstream sectors are not supported by robust evidence. Javorcik, above n 394, at 151.

[404] Alfaro and Rodriguez-Clare, above n 392, at 121.

[405] Brahmbhatt and Hu, above n 200, at 17; G. Blalock and P. J. Gertler, 'Foreign Direct Investment and Externalities: The Case for Public Intervention', in T. H. Moran, E. M. Graham, and M. Blomström (eds), *Does Foreign Direct Investment Promote Development?* (Washington DC: Institute for International Economics, 2005), 73-106, at 79; Javorcik, above n 394, at 146 and 149. A spillover would be present if the enhanced productivity of suppliers also results in lower prices to other firms in the local economy. Moran, Graham, and Blomström, above n 390, at 3.

[406] Bitzer and Görg, above n 396, at 222. Carkovic and Levine have found that FDI does not exert an independent influence on economic growth and, therefore, reject the case for subsidizing FDI. Yet, other authors in the same volume reject their findings. M. Carkovic and R. Levine, 'Does Foreign

justification for subsidizing FDI but the mixed evidence on horizontal spillovers warrants that the benefits of FDI should certainly not be overestimated and that the overall result might even turn out to be negative.[407] As a general rule, the value of any subsidy should certainly not exceed the positive externality generated by FDI, but the difficulty in measuring this magnitude of potential positive spillovers (if any) makes this a thorny exercise.[408] The absorptive capacity of the host country as well as the particular industry seems to form a crucial factor determining whether or not positive spillover effects are generated by FDI, suggesting a role for investing in human capital and local R&D.[409] Whereas the question on whether *incentives* should be given to attract FDI is thus still open, Moran et al nonetheless conclude that *restrictive* policies on FDI (e.g., local content requirements, technology sharing regulations) and trade are certainly not conductive for spurring economic growth through FDI as these host country policies are unlikely to generate intra-industry spillovers. Restrictive policies on FDI would lead to ‘outdated technology, inefficient production processes, and a wasteful use of host country resources’.[410] The gains from knowledge attached to imported intermediate products as well as its disincentive effect on attracting FDI in the first place might further question the validity of local content requirements.[411] Moreover, FDI to protected trade regimes (market-seeking FDI; e.g., motivated by tariff jumping) is less likely to generate positive spillovers as the absorptive capacity of the local industry is often insufficient.[412]

2.4.5. In conclusion: From infant industry protection to infant industry promotion

Empirical evidence resulting from the experience of the ‘East Asian Miracle’ has shown that an outward-oriented (EP) strategy offers more guarantees than an inward-oriented (IS)

Direct Investment Accelerate Economic Growth’, in T. H. Moran, E. M. Graham, and M. Blomström (eds), *Does Foreign Direct Investment Promote Development?* (Washington DC: Institute for International Economics, 2005), 195-222; Moran, Graham, and Blomström, above n 392, at 377-382, 389-390.

[407] Strictly speaking, only in the presence of true knowledge spillovers (see above n 405) could a case for public intervention be made on the basis of knowledge transfers. Another market failure justifying policy intervention, although only for first movers, is related to information asymmetries inhibiting potential foreign investors to invest in a new location and demonstrating profitability once new foreign investors are located (demonstration effect). See Harding and Javorcikr, above n 392, at 9; Moran, Graham, and Blomström, above n 390, at 4; Javorcik, above n 394, at 156. Lastly, Blalock and Gertler point to the role of providing credit liquidity in times of financial crisis as a justification for public intervention so as to attract FDI. Blalock and Gertler, above n 405, at 102-104.

[408] Commission on Growth and Development, above n 149, at 42.

[409] In the words of Nunnenkamp, ‘(f)or all we can tell, however, it appears much more difficult to benefit from FDI than to attract FDI’. P. Nunnenkamp, To What Extent Can Foreign Direct Investment Help Achieve International Development Goals?, 27:5 *The World Economy* (May, 2004), 657-677, at 674.

[410] At the same time, the success of the China’s Special Export Zones is also documented by the same authors.

[411] World Development Report 2005, above n 253, at 171; Brahmbhatt and Hu, above n 200, at 38.

[412] See also Nunnenkamp, above n 409, at 674.

strategy for reaching sustained economic growth. Further, the 2008 World Trade Report also observed important similarities between this East Asian Miracle and China's recent growth process: the take-off was marked by a shift towards outward-oriented policies and China gradually demonstrated its ability to upgrade its performance in technologically more advanced sectors.[413] Reviewing all 13 'success stories' of high sustained growth since the postwar period, the Growth Commission's central lesson entailed that the integration in the global economy formed a critical ingredient of these countries' transformation from an agriculture-dependent towards a more diversified economy (e.g., labor-intensive manufacturing).[414] An inward-looking strategy might have worked occasionally (e.g., Brazil[415]), but always reached its limits.

Theoretical arguments are also advanced explaining the superiority of an outward-oriented strategy, although such a strategy might be combined with an import-substitution policy in selected sectors during a first phase.[416] First, one disadvantage of the inward-looking strategy is that the 'infant industries' rely on the *domestic market* to grow up.[417] Here, this domestic market might often be too small in the first place to produce at an efficient level and grasp economies of scale.[418] In addition, the advantage of an export promotion strategy is that world market demand is relatively elastic and that output could thus be expanded as productivity grows without incurring a sharp price decline (terms of trade), whereas an inward-looking strategy focuses on the limited domestic market with a much more inelastic demand. Equally, the larger world market also allows for more specialization. Second, the endogenous growth theory shows that the restrictive trade regime resulting from an inward-looking strategy implies that those countries are cut off from *dynamic gains from trade*.[419] In particular, it has been argued that knowledge spillovers attached to exportation and importation could be important for inducing growth, although evidence is not conclusive.[420]

[413] Yet, the Report also acknowledged that it is debated to what extent the performance of China is export-led. World Trade Report 2008, above n 125, at 74; Frieden, above n 218, at 421-426.
[414] These countries are: Botswana, Brazil, China, Hong Kong, China, Indonesia, Japan, the Republic of Korea, Malaysia, Malta, Oman, Singapore, Taiwan, China, and Thailand. Two other countries, India and Vietnam, may be on their way to join this group.
[415] The Report observes how, at first glance, Brazil 'sits uneasily beside the other 12' as it successfully implemented an IS-strategy until the 1980s by relying on a large domestic market and abundant agricultural resources. Yet, economic growth lost its momentum in the 1980s. Commission on Growth and Development, above n 149, at 21.
[416] The above mentioned examples of semi-conductor protection and promotion in Japan and the aircraft protection and promotion in Europe might illustrate such a combination. Bhagwati also observed that in most East Asian countries the EP-strategy was combined with import-substitution in selected sectors. Bhagwati, above n 213, at 27-57; Frieden, above n 218, at 421.
[417] The failure to encourage exports under an IS-strategy is also called the home market bias. See Corden, above n 24, at 24-27.
[418] Or, the domestic market might be so small that only a few firms could operate, implying monopoly or quasi-monopoly positions. Krueger, above n 220, at 515; Bhagwati, above n 213, at 39.
[419] See, for example, Krueger, above n 220, at 1518; Messerlin, above n 207, at 1359-1407.
[420] Next to a competition effect (see above n 360 and n 363).

By spurring exports and imports, an outward-oriented strategy might generate important channels for 'learning-by-imitation' and hence result in faster productivity catch-up. Third, a restrictive trade and investment regime would be less likely to attract *FDI* that generates positive spillovers. Market-seeking FDI attracted under an import-substitution regime (e.g., tariff jumping) would be inferior to efficiency-seeking FDI.[421] Fourth, the specific *market failures* underpinning the case for active government intervention call for subsidies instead of for tariff/QR protection.[422] Indeed, subsidized credits – and not import restrictions – are second-best solutions for correcting capital market failures. Moreover, targeted subsidies to first-movers are optimal for inducing discovery and the externalities creating coordination failures (e.g., knowledge spillovers) also call for subsidization (e.g., R&D subsidies) instead of for import protection.[423] Generally speaking, a production subsidy is more appropriate than an import restriction for spurring domestic production that is too low due to a domestic market failure, as the latter also negatively affects domestic consumers.[424] Hence, the infant industry argument invites promotion, rather than protection.[425] Fifth, an outward-oriented strategy might generally offer more guarantees that *government failures* do not 'make things worse'. In contrast to an IS-strategy generating tariff revenue, subsidization as part of an outward-oriented strategy entails a cost to the government and therefore induces the government to (re-) think twice in supporting an industry.[426] Moreover, an IS-strategy provides no guarantee that the protected infant will ever grow up, whereas a subsidy contingent upon export performance could be employed under an outward-oriented strategy to ensure that only 'winners' will be awarded (performance criteria).

Nonetheless, the empirical evidence as well as theoretical arguments on the superiority of an outward-oriented strategy still cover large differences in viewpoints.[427] According to the Growth Commission Report, 'the crucial role of exports in their success is not much disputed (…) (b)ut the role of export *promotion* is'.[428] On the one hand, the neoliberal school would downplay the specific government interventions in explaining the export growth of the success stories and underline those theoretical arguments of an outward-oriented strategy that

[421] See also Bhagwati, above n 213, at 38.
[422] See also Messerlin, above n 207, at 1400; Baldwin, above n 221, at 303-304.
[423] Given that a product could also be produced using a backward technology, import protection is not a good instrument for inducing the use of new technologies. Rodriguez-Clare, above n 298, at 3-32.
[424] An *export* subsidy also negatively affects consumers in the domestic market. See Bagwell, above n 25; K. Bagwell and R. W. Staiger, 'Will International Rules on Subsidies Disrupt the World Trading System?', *The American Economic Review* (June, 2006), 877-895; M. J. Melitz, 'When and How Should Infant Industries Be Protected?', 66 *Journal of International Economics* (2005), 177-196, at 179.
[425] Johnson, above n 76, at 256.
[426] See, for example, Bhagwati, above n 213, at 37.
[427] Such disagreement is also related to the question on the extent to which an import-substitution strategy could be warranted in the first phase of economic development and/or in selected sectors.
[428] Commission on Growth and Development, above n 149, at 48.

fit a free trade agenda (arguments 1-3).[429] This school is much more skeptical about the usefulness of specific and functional government interventions, which would go beyond general investments in human (e.g., education, health) and physical capital (e.g., general infrastructure). On the other hand, authors being more skeptical about the intrinsic benefits of trade and FDI (e.g., Rodrik) point to the tradable sector's market failures which could and should be corrected by those instruments through which an outward-oriented strategy is promoted as well (e.g. (export) subsidies) (arguments 4-5).[430]

Reconciling aspects of both views, the new paradigm expressed in the 2009 World Bank study and Growth Report seems to take on board all the listed benefits of an outward-oriented strategy (arguments 1-5). Here, the benefits of opening up to trade are emphasized. At the same time, it is recognized that such benefits often do not flow automatically from trade opening but might require active government intervention to overcome market failures and that the exact implementation thereof depends on the characteristics of each country ('one size does not fit all'). Such a country-specific outward-oriented strategy suggests that S&D treatment for developing countries might be more important at their export side (e.g., need for subsidization, access to markets in developed countries) than at their import side (e.g., border charges).[431]

What is more, the Aid for Trade agenda launched under the Doha Round suggests that this policy space might even be insufficient and that development aid is needed to help those countries grasping the benefits of trade opening. Next to trade-related infrastructure (which has a strong public good characteristic), one of the other categories on the Aid for Trade agenda is 'productive capacity building', which includes 'supporting the private sector to exploit their comparative advantages and diversify their exports' (covering agriculture, industry as well as services).[432] An interesting question is to what extent this Aid for Trade agenda fits with the rationale of – and disciplines imposed under – the SCM Agreement.[433] One of the main novelties of the SCM Agreement was precisely its introduction of more stringent disciplines on certain developing countries. Indeed, the successful outward-oriented strategy that was used by the Asian tigers and that started to threaten knowledge-intensive

[429] See, for example, A. Panagariya, 'Evaluating the Case for Export Subsidies', *World Bank Policy Research Working Paper* No. 2276 (January 2000), 30 pp.

[430] Although the specific market failures rather call for subsidization, trade protection is also considered as a complementary instrument because less weight is attached to the benefits of trade. See, for example, Rodrik, above n 242, at 8 and 19-20. Somewhat anecdotical, Rodrik's biography invited him to consider himself as 'the creation of import substitution'. See L. Uchitelle, 'A Global Balancing Act', *The New York Times* (30 January 2007).

[431] See below on the different approaches towards S&D treatment in the GATT/WTO history. See also above n 218.

[432] OECD, *Aid-for-Trade data: Creditor Reporting System – Explanatory Note* (Paris: OECD), 8 pp., at 1.

[433] The Aid for Trade-agenda mainly focuses on LDCs, which are exempted from many disciplines on subsidies (see below Part II, Chapter 6, Section 6.1).

sectors of developed countries in the 1980s, explains why developed countries have pushed for such strengthened disciplines during the Uruguay Round. This raises the normative question (addressed in Part IV) whether the SCM Agreement leaves sufficient policy space for the different types of developing countries to implement an outward-oriented strategy.

Yet, the call for an outward-oriented strategy also raises an economic puzzle: can all countries pursue such outward-oriented strategy at the same time (added-up problem)?[434] What is good for one country in isolation might be logically inconsistent if generalized.[435] Two reasons might indeed suggest that export-led growth cannot add up: if all developing countries start to exploit their surplus labor by setting up labor-intensive sectors, the price of those goods might be depressed, whereas a flood in exports might equally give rise to a protectionist reflex in other countries. These effects at the supply and demand side would negatively affect the terms of trade of exporting developing countries and thus their return on such investments. In particular, the boom of Chinese exports in labor-intensive manufacturing has depressed the relative price of labor-intensive manufactured goods (crowding-out effect). Nonetheless, several reasons suggest that it would still be beneficial for low-income countries to diversify exports into labor-intensive industries. First, their low labor cost would still make their return of investment positive and their potential aggregate supply would be relatively low compared to world demand. Second, the 'product ladder' phenomenon suggests that developing countries move on the ladder of comparative advantage and exit labor-intensive industries if their income rises. The original Asian tigers have indeed largely left the labor-intensive industry. China forcefully entered this field but there is some evidence that it is already moving away from labor-intensive sectors as it is growing rapidly.[436] Third, these developing countries' growth generates additional demand and thus increases export opportunities for other countries (complementarity effect).[437] Fourth, the protectionist reflex in importing countries does not seem not to materialize, partly because of the existence of WTO disciplines.[438] Hence, low-income developing countries would still benefit from an outward-oriented strategy diversifying into labor-intensive manufactured goods.

2.5. Government intervention in times of global recession: The role of subsidies for recovery

Infected by a crisis in the US housing and financial markets in 2007-2008, the world economy in 2009-2010 faced its deepest economic recession since the Great Depression of the 1930s.

[434] Commission on Growth and Development, above n 149, at 94-96.
[435] This is also known as the 'fallacy of composition' problem. See Cline, above n 372.
[436] Qureshi and Wan also find that China's export structure is changing from labor-intensive products towards skill-intensive and medium-to high-technology products. M. S. Qureshi and G. Wan, 'Trade Expansion of China and India: Threat or Opportunity?', *The World Economy* (2008), 1327-1350.
[437] See Qureshi and Wan, above n 436, at 1327-1350. It could also generate knowledge spillovers.
[438] See Cline, above n 372, at 2 and 21.

Indeed, a combination of a reduction in wealth, a sharp decrease in available credit, and a loss of consumer and investment confidence has resulted in a large drop of aggregate demand and, in turn, of the volume of world trade, both larger than in any period since the 1930s.[439] To recover from this global recession, a successful policy response should have two components.[440]

First, measures aiming at revitalizing the financial sector should be put in place. As an immediate response, governments bailed out large financial institutions under stress, which was legitimized on the basis of the systemic risk that their potential bankruptcy would pose to the entire financial system and real economy ('too big to fail' argument). Next to such direct financial bailouts, reforming the financial regulatory system should be on the agenda in the longer run in order to efficiently ease this systemic risk, as it leads to moral hazard behaviour on the part of financial institutions.[441] By getting the financial system back on track, credit flows should revive, hereby stimulating investments and thus aggregate demand.

Second, macro economic policies directly stimulating aggregate demand should be implemented so that spending is brought back to the level at which the available productive resources are again effectively deployed and full employment is achieved. Indeed, due to price rigidity, such recovery in private demand does not occur automatically (at least not in the short run) but has to be accelerated by macro economic interventions in the form of monetary and/or fiscal policies.[442] Given that most developed countries have already used monetary expansion resulting in low interest rates, there is little room for further stimulating demand through monetary policy ('world liquidity trap').[443] Although some Chicago School scholars might still question its effectiveness, most economists, in particular those from the New Keynesian School (e.g., Krugman, Stiglitz), as well as international institutions such as

439 Some experts even suggest that the rate of contraction in merchandise trade was larger than that experienced during a similar stage of the Great Depression.

440 See, for example, A. Spilimbergo, S. Symansky, O. Blanchard, and C. Cottarelli, 'Fiscal Policy for the Crisis', *IMF Staff Position Note* (29 December 2008), 37 pp., at 2-3; P. Krugman, *The Return of Depression Economics and the Crisis of 2008* (New York: W.W. Norton & Company, 2009), 207 pp., at 181-191.

441 The financial bailout only aggravated such moral hazard behaviour.

442 If prices would fall quickly, demand would recover without government intervention. Reasons for price rigidity (e.g., wage rigidity, menu costs) are disputed among economists.

443 Nominal interest rates cannot be negative. There are a variety of reasons explaining why an expansive monetary policy does not substantively boost investments. First, the interest rate set by central banks is not necessarily channelled to investors as intermediate financial institutions might add a surcharge to compensate for their losses. Second, given nominal rates cannot be negative, they cannot prevent real interest rates from rising when prices fall. Third, investments are not only determined by the cost of borrowing but also by the expectation of profit. If the latter will fall below zero, no money will be borrowed. See R. Skidelsky, *Keynes – The Return of the Master* (London: Penguin Group, 2009), 214 pp., at 18.

the IMF, therefore agree that what is needed to break this vicious circle of deteriorating aggregate demand is 'good old Keynesian fiscal stimulus'.[444,445]

The IMF has advocated that such fiscal stimulus should be large, timely, lasting, contingent, collective, and sustainable.[446] Because of the uncertainty on what effectively works in response to the current crisis, such stimulus package should also be diversified, meaning that it should be composed of several different tools. First, the IMF, echoing Keynes, points to *public spending* on goods and services as the most effective tool because its direct effect on demand is larger than (income) tax cuts or transfers to households or firms, which are partly saved rather than spent. Public works generating large environmental externalities could be good examples thereof. The traditional argument against public spending, namely that it takes too long to generate effects, is considered less relevant given the recession's long duration.[447] Second, *fiscal stimulus aimed at consumers* could consist of transfers and income tax cuts, preferably targeted at those consumers most likely affected by credit constrains, but its effectiveness depends on the impact on the marginal propensity to consume. Likewise, the effectiveness of cuts in indirect taxes (e.g., VAT) or cash transfers for purchases (e.g., of more efficient cars) that were undertaken by some countries, also depends on whether they are sufficiently large to boost consumer spending.[448] Third, *fiscal stimulus aimed at producers* is put in place in several countries. In the IMF's view, the key challenge for policy-makers is in this respect 'to avoid that firms have to cut down their current operations for lack of financing, including reasonably-priced credit'. Given the private capital market's failure, the IMF sees a legitimate role for non-sector specific credit guarantees by governments for firms under economic distress, as this would facilitate their process of restructuring (in line of the IMF's 'lending plus policy adjustment' advice). On the other hand, direct subsidies to specific sectors (e.g., car sector in the US) could not be legitimized. Although the IMF accepts that bankruptcy of 'high-visibility' sectors may adversely affect expectations and thus demand, such support is inherently arbitrary and the risk of political capture (political-economy argument) makes proper implementation too difficult. Moreover, such direct subsidies create an 'uneven playing field' with foreign competitors, and thus could lead to retaliation and trade wars. Therefore, according to the IMF, an 'important principle of support should be to minimize interference with operational decisions'.[449] Yet, it is hard to

[444] Krugman, above n 440, at 187; 'Stiglitz Urges 'Powell Doctrine' to Fix Jobs Picture' *Bloomberg* (10 December 2009); 'Big government fights back', *The Economist* (29 January 2009). On the debate on the stimulus plan between the different schools, see Skidelsky, above n 443, at 46-51.
[445] However, others might have to be credited for inventing Keynesianism before Keynes. See Frieden, above n 218, at 240-241.
[446] Spilimbergo, Symansky, Blanchard, and Cottarelli, above n 440, at 3-9.
[447] Krugman, above n 440, at 183-184.
[448] In case of cuts in indirect taxes, their effect is also dependent on whether they are passed through to consumers.
[449] Spilimbergo, Symansky, Blanchard, and Cottarelli, above n 440, at 7.

see how fiscal stimulus measures aimed at producers under economic distress could adhere to this principle in practice.

In sum, demand and thus production could be boosted by increasing public spending as well as by stimulating private spending through fiscal incentives, targeted at either consumers or producers. The crux is that by raising income and confidence, such an expansionary fiscal policy multiplies its effect on GDP growth.[450] Yet, in an open economy, some of the fiscal stimulus spent by a government does not accelerate its national GDP growth (i.e., national multiplier) by boosting domestic production but leaks abroad in the form of increased imports and thus benefits other countries.[451] Because countries aim at maximizing their national multiplier and given increased imports may result in trade deficits, countries have an incentive (i) to set fiscal stimulus at a suboptimal low level and 'free ride' on stimulus packages taken by foreign countries, and/or (ii) to impose trade-distortive measures so as to prevent leakage when implementing their own stimulus package. Hence, to reach the Pareto-optimal outcome in this classic prisoner's dilemma, cooperation between countries is needed to ensure, as some have phrased it, both 'Keynes at home' and 'Adam Smith abroad'.[452]

The importance of implementing stimulus packages in a non-trade-distortive way and thus respects 'Smith abroad', is that it ensures that the generated demand is spent in the most efficient manner and that the 'global multiplier' (i.e., the rise in global GDP as a result of governments' spending) is maximized (Pareto-optimal outcome). As recognized by the WTO Director-General, in case subsidization can be undertaken, its full value as a stimulus for global activity will therefore 'come from targeting them at consumption, not production, with consumers free to choose internationally the goods and services that they buy'.[453] In contrast, trade-distortive fiscal stimulus measures are not neutral on the way the generated demand should be spent but rather induce spending towards, or directly offer support to, domestic products/services. Examples of such trade-distortive government stimulus measures are direct government spending containing a 'buy national' provision, but also fiscal stimulus aimed at domestic producers (e.g., car bailouts). Although individual countries might be tempted to prevent leakage abroad and maximize their national multiplier in this way, it diverts resource allocation from more efficient foreign producers to less efficient domestic producers and therefore 'acts like a tax on income and production'[454], undermining the 'global

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[450] At the same time, an accommodating monetary policy that prevents interest rates from rising as a result of fiscal expansion should be put in place, as this would undercut demand again.

[451] See, for example, O. Blanchard, *Macroeconomics* (New Jersey: Prentice Hall, 1997), 623 pp., at 232-238.

[452] See F. Erixon and R. Sally, 'Keynes at Home, Smith Abroad - Domestic Stimulus Spills Over to Protectionism', *The Wall Street Journal* (9 September 2009).

[453] *Report to the TPRB from the Director-General on the Financial and Economic Crisis and Trade-related Developments* (JOB(09)/30, 26 March 2009), para 8.

[454] Report to the TPRB from the Director-General, above n 453, para 43.

multiplier'. Moreover, such trade-distortive government stimulus could even be counterproductive for their 'national multiplier' as their adverse effects on foreign producers competing in the same contracted market could trigger retaliation by other countries (e.g., raising import barriers or competitive subsidization) and thus result in a trade war, hereby further deteriorating the 'global multiplier'.[455] Recalling Lawrence's observation regarding subsidization in the 1980s, subsidizing industries in sectors confronted with great excess capacity (e.g., steel) during periods of high unemployment leads to 'the exportation of unemployment', inducing trade responses by trading partners.[456] The WTO Director-General equally referred to 'the failure of trade restrictions and subsidies to provide effective industrial support in the 1970s and 1980s, and the long-term costs imposed on world trade until they were unwound during the Uruguay Round'.[457] In Part IV, we will examine whether the existing legal framework on subsidy disciplines can effectively guarantee that 'the same mistakes (are) not … made again'[458] in countries' responses to the current crisis.[459]

At the same time, one has to recognize that if international disciplines ensure 'Smith abroad', this might inhibit 'Keynes at home' as countries open to trade might have an incentive to just wait for Keynes to come from abroad.[460] Therefore, coordination is needed to ensure that countries effectively implement their own fiscal stimulus. This coordination mainly takes place in the IMF as well as in the G-20 setting, which brings together industrial and emerging-market industries.[461][462] Apparently, coordination among G-20 countries seems to have been rather successful so far. After some initial hesitance,[463] they reached the IMF's

[455] On competitive subsidization in the car industry, see, for example, A. O. Krueger, 'Trade Openness Is Now More Important Than Ever', *World Bank Institute, Development Outreach* (December 2009), 37-49, at 38.
[456] See above Part I, Chapter 2, Section 2.5.
[457] Report to the TPRB from the Director-General, above n 453, para 7.
[458] Report to the TPRB from the Director-General, above n 453, para 7.
[459] See below Part IV, Chapter 5. Determined to 'not repeat the historic mistakes of protectionism of previous eras', G-20 Leaders at the 2010 London meeting had promised 'to refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing WTO inconsistent measures to stimulate exports' until the end of 2010, and to '...minimize any negative impact on trade and investment of our domestic policy actions including fiscal policy and action in support of the financial sector'. Only a few days before, the WTO Director-General had observed a 'significant slippage' towards protectionist actions. See G-20, *The Global Plan for Recovery and Reform* (2 April 2009), para 22.
[460] See Blanchard, above n 451, at 238; J. Stiglitz, 'The Imperative for Improved Global Economic Coordination', *World Bank Institute, Development Outreach* (December 2009), 39-42.
[461] This should not be confronted with the G-20 coalition in the Doha Negotiations (see below Part II, Chapter 1, Section 1.5).
[462] Compared to the situation in which a region acts alone in implementing fiscal stimulus, simultaneous fiscal stimulus could raise each region's multiplier by a factor of about 1.5 as a result of international spillovers of demand. See C. Freedman, M. Kumhof, D. Laxton, and J. Lee, 'The Case for Global Stimulus', *IMF Staff Position Note* (March 2009), 27 pp.
[463] See, Report to the TPRB from the Director-General, above n 453, para 45.

proposed additional total stimulus of around 2 per cent of world GDP ($ 1.2 trillion) for 2009.[464]

Developing countries have far less 'fiscal space' than developed countries to implement such expansionary fiscal policies in response to the economic downturn,[465] even though they were severely affected by a 'sudden stop' of capital inflows as well as by a collapse in export demand, which in turn caused a deterioration of domestic credit conditions and sharp fall in aggregate demand.[466] Hence, for these countries, it is pivotal that stimulus plans by other countries are implemented in a non-trade-distortive way so that their export sectors could benefit from additionally generated demand abroad (leakage). Further both the IMF and World Bank have rather fruitfully urged for a substantive increase in official financing to these countries so as to somewhat expand their own 'fiscal space'.[467] Next, the IMF suggested that exchange rate depreciation might be one of their few available options. Even though this is by definition not an option for the world as a whole, it would in particular be advisable for those developing countries that incurred a terms of trade loss, though not for those developing countries (e.g., China) having a large current account surplus.[468] Lastly, the tightening of available credit as well as the re-assessment of risks by commercial banks has resulted in a sharp increase in the cost of trade finance instruments for developing countries' importers and exporters. In response, international institutions such as the World Bank, IMF, and even the WTO have welcomed the G-20 pledge in April 2009 to ensure availability of at

[464] Yet, it was also observed that revenue measures and social transfers have been implemented more quickly than infrastructure projects, even though the latter have a large multiplier effect. At the April 2009 London Summit, the G-20 Leaders had pledged that an 'unprecedented and concerted fiscal expansion' would be undertaken, which would amount to $5 trillion by the end of 2010 and would 'raise output by 4 per cent, and accelerate the transition to a green economy'. See G-20, *The Global Plan for Recovery and Reform* (2 April 2009), para 6; See also G-20, *Leaders' Statement – The Pittsburgh Summit* (September 24-25 2009); G-20, *Progress Report on the Actions of the London and Washington G-20 Summits* (5 September 2009); IMF, ''Istanbul Decisions' to Guide IMF as Countries Shape Post-Crisis World', *IMF Survey Online* (6 October 2009).

[465] Fiscal space is defined by the IMF as 'the scope for financing a deficit without undue crowding out of private activity, sharp increases in funding costs, or undermining debt sustainability'. See A. R. Ghosh, M. Chamon, C. Crowe, J. I. Kim, and J. D. Ostry, 'Coping with the Crisis: Policy Options for Emerging Market Countries', *IMF Staff Position Paper* (April 23, 2009), 29 pp., at 5.

[466] See Ghosh, Chamon, Crowe, Kim, and Ostry, above n 465, at 3. The World Bank calculated that the crisis would result in a surplus of 53 million people living in extreme poverty (below $1.25 a day) and would jeopardize the progress made on reaching the Millennium Development Goals (MDGs). See World Bank, *World Bank Group Response to the Financial Crisis* (24 March 2009), at 1.

[467] World Bank President Zoellick suggested that developed countries contributed an equivalent to 0.7 per cent of their stimulus packages as additional aid. See World Bank, *World Bank Group Response to the Financial Crisis* (24 March 2009); Ghosh, Chamon, Crowe, Kim, and Ostry, above n 465, at 8; G-20, *The Global Plan for Recovery and Reform* (2 April 2009); G-20, *Leaders' Statement – The Pittsburgh Summit* (24-25 September 2009); G-20, *Progress Report on the Actions of the London and Washington G-20 Summits* (5 September 2009).

[468] Ghosh, Chamon, Crowe, Kim, and Ostry, above n 465, at 6, 15-19.

least $250 billion over the next two years to support trade finance.[469] Apparently, this pledge is successfully implemented. Still, as Part III of this dissertation will show, it is highly questionable whether this could be done in a WTO consistent way under the current rules.[470]

[469] G-20, *The Global Plan for Recovery and Reform* (2 April 2009); OECD, Working Party on Export Credits and Credit Guarantees, *Statement: The Global Financial Crisis and Export Credits* (TAD/ECG(2009)3, 23 April 2009).
[470] On its implementation, see M. Auboin, 'Restoring Trade Finance During a Period of Financial Crisis: Stock-taking of Recent Initiatives', *WTO Working Paper* (December 2009), 24 pp., at 16-19; G-20, *Progress Report on the Actions of the London and Washington G-20 Summits* (5 September 2009); G-20, *Progress Report on the Economic and Financial Actions of the London, Washington and Pittsburgh G20 Summits* (7 November 2009).

3. NON-ECONOMIC RATIONALES FOR SUBSIDIES AND COUNTERVAILING DUTIES

This paragraph addresses distinct non-economic reasons explaining subsidization and the imposition of countervailing duties. First, consensus is emerging that industrial policy should not merely focus on economic growth *sensu stricto* but on the broader concept of sustainable development. Subsidies related to environmental protection exactly aim at correcting market failures inhibiting sustainable development (Section 3.1). Second, the discussion on multifunctionality in agriculture will illustrate that, next to market failures inhibiting economic development *sensu strictu* or sustainable development, markets might also be seen as failing to honour non-economic concerns such as landscape preservation or food security (Section 3.2).[471] Third, in case of subsidization for reasons of redistribution, subsidies do not aim at correcting a certain market failure but at changing the market outcome for reasons of equity or political stability (Section 3.3). Fourth, the 'political-economy' rationale for subsidies and CVDs is fundamentally different from all the previous (non-)economic rationales as the assumption that governments aim at maximizing (non-)economic welfare of their constituencies is replaced by the assumption that politicians simply aim at maximizing their *own* welfare (Section 3.4).

3.1. ENVIRONMENTAL PROTECTION

The international community displays a growing recognition that economic growth can only be supported insofar it is sustainable, which 'implies meeting the needs of the present without compromising the ability of future generations to meet their own needs'.[472] Yet, a variety of market failures explains why markets do not generate such a sustainable development outcome on their own. This could be illustrated by two examples.

First, environmental degradation generated by production or consumption (e.g., greenhouse gas emissions) represents a classic example of a negative externality because this environmental cost upon society (marginal external cost) is not reflected in the market price, which merely reflects marginal costs of production. As producers (consumers) do not have to pay for the marginal *external* costs, they produce (consume) too much from a socially optimal point of view.[473] Government intervention is thus warranted in order to this cost to be internalized and the market price to reflects the marginal social cost of production[474] (consumption), implying that output levels are reduced. However, two elements might put doubt on whether individual governments' efforts will reach the socially optimal outcome

[471] Another example, not further discussed, is the protection of cultural heritage.

[472] United Nations, General Assembly, *Report of the World Commission on Environment and Development* (A/RES/42/187, 11 December 1987).

[473] See also M. S. LeClair and D. Franceschi, 'Externalities in International Trade: The Case for Differential Tariffs', 58 *Ecological Economics* (2006), 462– 472.

[474] Marginal cost of production plus the marginal external cost.

implementing such 'polluter pays' principle. First, in case negative externalities are international in nature (e.g., climate change), individual governments' incentives to correct such market failure might be too low from a global perspective, as part of the marginal external cost falls on others.[475] Second, if the 'polluter pays principle' is introduced in some countries but not in others, this might hamper the competitiveness of those producers subjected to such principle and undermine the effectiveness of environmental protection, as those producers might simply choose to relocate to countries with weaker environmental policies ('carbon leakage').[476] Tackling these free rider problems in an optimal way requires international cooperation (e.g., Kyoto Protocol).[477] Insofar such cooperation has not equalized environmental protection among countries (e.g., no internationally agreed price on carbon[478] reflected by the non-universal acceptance of the Kyoto Protocol), both concerns remain and present the question to what extent WTO disciplines allow individual countries to correct, at the import as well as at the export side, the negative impact on their producers' competitive position so as to prevent carbon leakage.[479]

Second, production (or consumption) of certain goods or services might generate positive externalities (e.g., 'green technology'), whereby the positive external benefits on society are not appropriated by producers making the investment.[480] Accordingly, such positive externality leads to underinvestment in the production in question (e.g., solar energy technology[481]) and government intervention is again needed.[482] The socially optimal level of

[475] A. V. Deardoff, 'International Conflict and Coordination in Environmental Policies', in J. S. Bhandari and A. O. Sykes (eds), *Economic Dimensions in International Law – Comparative and Empirical Perspectives* (Cambridge: Cambridge University Press, 1997), 248-274, at 256-257.
[476] WTO – UNEP Report, *Trade and Climate Change* (Geneva: WTO Publications, 2009), 166 pp., at 98. Van Calster has suggested that such reallocation might not only neutralize but even worsen environmental protection as firms would reallocate to countries with less stringent environmental standards overall. See G. Van Calster, *International & EU Trade Law – The Environmental Challenge* (London: Cameron May, 2000), 564 pp., at 421.
[477] Multilateral efforts to reduce greenhouse gas emissions are listed in the WTO – UNEP Report, above n 476, at 68-83.
[478] WTO – UNEP Report, above n 476, at 98.
[479] In the WTO – UNEP Report, competitiveness is defined as the 'ability to maintain profits and market shares'. WTO – UNEP Report, above n 476, at 98. Aichele and Felbermayr have found that the non-universal acceptance of the Kyoto Protocol has, on average, led to substantive carbon leakage. See R. Aichele and G. Felbermayr, 'Kyoto and the Carbon Content of Trade', *FZID Discussion Paper* No. 10-2010 (2010), 63 pp.
[480] The benefit (positive impact on climate change) has public good characteristics as it is non-rival in consumption and non-excludable. On the other hand, such subsidization would not be needed in case the negative externality caused by environment-unfriendly products would be fully internalized.
[481] Interestingly, the 2006 World Trade Report gives the example of solar energy technologies, which is actually one of the fields in which companies of different countries (e.g., Germany, China, and US) are fiercely competing for market shares and whereby those governments actively intervene by different forms of subsidization.
[482] This argument for government intervention does not rest on the social external benefit in the form of knowledge that can be appropriated by others, but in the form of positive effects on the environment. Subsidies for R&D on environmentally green technologies might thus be legitimized on double grounds.

output is higher than the free market level.[483] Here, the question arises to what extent government incentives to spur output levels are restricted under the SCM Agreement. In principle, individual governments would underinvest in such promotion in case positive externalities are international in nature.

In sum, both market failures legitimate a corrective role for governments, who should opt for those instruments (e.g., taxes, subsidies, standards, and technical regulations) targeting the market failure as directly as possible (targeting principle). The debate on climate change could serve as a topical example of how governments have in practice developed such instruments with regard to an international externality. The 2009 WTO – UNEP Report has grouped these interventions into three categories.

First, governments have developed price and market mechanisms to internalize the environmental costs of greenhouse gas emissions (negative externality). For example, a 'carbon tax', which is a tax based on CO_2 emissions, is levied by several countries on the use of fossil fuels and is often directly levied on consumption (tax 'at the pump').[484] In theory, an optimal carbon tax would implement the 'polluter pays principle' and thus be set at a level that internalizes the marginal external cost on the environment (so-called 'Pigouvian tax'), which corresponds to a socially optimal level of pollution.[485] Taxing production levels of CO_2-intensive industries instead of directly taxing CO_2 emissions would only be a second-best solution as it is less targeted on the source of the distortion. Compared to taxing CO_2 emission, subsidizing CO_2 emission reductions would equally reduce firms' emission levels but is in the long run inferior as well, as it could induce firms to enter the market, thus lead to more pollution overall, and does not correspond with the 'polluter pays principle' [486] Similar to a carbon tax, emission trading schemes could also ensure that emission reductions will be

[483] World Trade Report 2006, above n 9, at 99-100. Next to these two examples, the report also points to public goods characteristics of certain environmental resources. For example, fish stocks or woods are so-called 'impure' public goods or 'common property resources' (as these are non-excludable but rival in consumption), which lead to free rider problems as individuals acting in their self-interest have the incentive to capture the limited available resources as quickly as possible before someone else captures them. Individuals do not calculate the cost their actions have on society (social external cost), namely how they reduce the overall stock of resources (negative externality). Hence, over-exploitation will be the result if no restrictions (e.g., regulation, government ownership, single ownership) preventing such a so-called 'tragedy of the commons' are installed. Another market failure is asymmetric information between consumers and producers about the quality of the good or the environmental standards used in the production process. See also Pindyck and Rubinfeld, above n 86, at 642-643.

[484] Although I use it as a synonym for a 'carbon tax', an 'energy tax' is in fact a broader concept as it is based on the energy content of energy sources and could thus also be imposed on carbon-free energy sources. WTO – UNEP Report, above n 476, at 90-91.

[485] WTO – UNEP Report, above n 476, at 96; World Trade Report 2006, above n 9, at 100.

[486] The 'polluter pays principle' holds that environmental resources are publicly owned and that those who damage such resources should pay for it. World Trade Report 2006, above n 9, at 100-101.

achieved in an efficient way.[487] Such cap-and-trade schemes '(i) fix a cap on total emissions, (ii) translate this cap into 'allowed emission' or allowances to cover emissions, and (iii) create a market in which these allowances can be auctioned and/or traded, at a price set by the market (i.e., tradable allowance system)'.[488]

Second, governments have developed financial mechanisms to promote the development and deployment of climate-friendly goods and technologies. Next to the positive environment externality generated by such goods and technologies, the WTO – UNEP Report lists a number of other market failures (e.g., positive R&D externality) legitimizing such governmental funding.[489] Such measures include for example subsidies (e.g., grants or fiscal measures) for (i) R&D of greenhouse gas emission-reducing technologies or renewing energy technologies, (ii) offsetting the cost of installing emission-reducing technologies, or (iii) using climate-friendly inputs. Development and deployment could therefore be stimulated at the production as well as at the consumption side.

Third, governments have installed technical requirements (in the form of mandatory technical regulations or voluntary standards) for products as well as for production methods which generally aim at improving their energy efficiency and reduce their emission levels during consumption or processing.[490.] In fact, such requirements are an alternative way to internalize negative or positive environmental externalities generated by the production or consumption of goods or technologies.[491]

In Part IV, the analysis will address to what extent the WTO Agreements, and in particular the SCM Agreement and the Agreement on Agriculture, offer policy space for governments to implement these three types of measures as well as to counteract against failure of third countries to internalize negative externalities.[492]

3.2. MULTIFUNCTIONALITY IN AGRICULTURE

The concept of 'multifunctionality' in the context of agriculture reflects the idea that agriculture has many functions in addition to producing commodities, such as environmental

[487] In case of a carbon tax, the price on greenhouse gas emissions is set by the government, while the quantity of emission reductions is determined by the industry. In case of emission trading schemes, the quantity of emission reductions is set by the government, while the price is determined by the market. Depending on whether price certainty is more important than quantity certainty, a carbon tax system might be superior to an emission trading system. WTO – UNEP Report, above n 476, at 97-98.
[488] WTO – UNEP Report, above n 476, at 91.
[489] For example, companies investing in such technologies may not be successful in convincing private investors because they may be unable to demonstrate the environmental effectiveness of their product until it has been brought into use on a large scale. WTO – UNEP Report, above n 476, at 110-111. Of course, the latter rationale assumes a failure in the capital market.
[490] WTO – UNEP Report, above n 476, at 117.
[491] They could also be legitimized on the basis of asymmetric information between producers and consumers. On the effectiveness of such regulations and standards, see WTO – UNEP Report, above n 476, at 123-124.
[492] See below Part IV, Chapter 2, Section 2.1.1.2.

protection, landscape preservation, rural employment, and food security (non-commodity outputs).[493] Domestic production is considered to generate positive externalities in the form of non-economic societal benefits which a society deems appropriate to protect. Some of these so-called 'non-trade concerns' or non-commodity outputs are explicitly recognized in the preamble of the Agriculture Agreement (i.e., food security and environmental protection) as well as in the Doha Ministerial Declaration.[494] As OECD studies have demonstrated, the assumptions needed for legitimizing government intervention are that these other functions (non-commodity outputs) reflect external benefits from commodity production, for which no functioning private market exists (market failure in non-commodity production because of public goods characteristics) and for which domestic commodity production is needed (jointness of production).[495] For example, a rural landscape has public goods characteristics (non-rival in consumption and non-excludable) for which domestic production of commodities might be required. Because domestic farmers are not compensated for this external benefit as it is not reflected in the market price, payments to farmers could be appropriate. Importantly, the case for stimulating domestic production thus hinges on the premises that a rural landscape is considered by a society as an external benefit not delivered by the market and that domestic production is needed to this end: a rural (or equally satisfying) landscape could not be obtained in another, more efficient way. If both conditions are fulfilled, the most efficient government intervention depends on the nature of jointness and the nature of the specific public goods characteristics of the non-commodity output. For instance, a production or output subsidy would not be sufficiently targeted in the likely case that non-commodity outputs are not directly linked to the level of production, but for example to the amount of land (e.g., rural landscape).[496] If so, area payments conditional on the delivery of the non-commodity output would be more appropriate. The OECD only considers output or production subsidies recommendable when a direct or fixed link is present between non-commodity output and production intensity at farm level.[497] Thus, the pivotal question

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[493] WTO Secretariat, *Glossary of Terms*. In broader terms, 'multifunctionality' refers 'to the fact that an economic activity may have multiple outputs and, by virtue of this, may contribute to several societal objectives at once'. OECD, *Multifunctionality, Towards an Analytical Framework* (Paris: OECD, 2001), 159 pp., at 11.

[494] To be precise, the preamble of the Agriculture Agreement does not explicitly link food security and environmental protection to the need for domestic production. Article 20 of the Agriculture Agreement also indicates that non-trade concerns should be taken into account in the reform process. See also WTO, *Doha Ministerial Declaration* (WT/MIN(01)/DEC/1, 20 November 2001), para 13.

[495] Even in case those assumptions are fulfilled, government intervention might not always be the most efficient strategy. Non-governmental options such as facilitating market creation or voluntary provision might be preferable. OECD, above n 493, at 23.

[496] Output subsidies 'to sustain this minimum level of commodity production would generally be inefficient since they are likely to stimulate the production intensity above this minimum level'. OECD, *Multifunctionality, The Policy Implications* (Paris: OECD, 2003), 106 pp., at 43.

[497] OECD, *Multifunctionality, The Policy Implications* (Paris: OECD, 2003), 106 pp., at 44.

seems whether production or output subsidies respect the targeting principle for correcting market failures.

The OECD studies further indicate that the inclusion of some non-commodity outputs in the debate on 'multifunctionality' of agriculture is contested. For example, 'rural employment' is an input and not a non-commodity output of agriculture. Yet, it could have consequences on societies that could be labelled as positive externalities (e.g., slowing the migration from rural to urban areas). Again, the pivotal question is whether such regional employment is a joint product of rural production and could not be reached in a more efficient way.[498] The inclusion of 'food security' is equally disputed in this framework because it assumes that domestic production secures and not hampers food security.[499] The premise is that domestic production reduces the probability of food shortage caused by disruption in imports (resulting from e.g., wars, embargoes, price shocks, or natural disasters). This contribution to food security, which is non-excludable in consumption, is however not reflected in the market price and this positive externality generated by domestic production therefore legitimizes subsidization. But the jointness of production could once more be questioned as domestic production not necessarily generates food security, nor might it be the most efficient way to do so.[500,501] Likewise, it could be argued that maintaining domestic production by subsidization could even generate negative externalities related to food security as it could reduce diversification of imports and innovation. Therefore, the net contribution of domestic production to food security is an empirical question.[502]

The major disagreement among WTO Members in essence concerns the existence and the nature of jointness of production of commodity and non-commodity outputs. On the one hand, several developed WTO Members (e.g., Japan, Korea, Norway, Switzerland, and the EC) rely on the multifunctionality argument to underpin their plea for policy space domestic support linked to production (e.g., amber and blue box support).[503] In their view, such production-stimulating support is needed in their view to grasp the non-trade benefits. On the

[498] OECD, above n 493, at 74-75.
[499] According to the 1996 World Food Summit, food security is obtained 'when all people, at all times, have physical and economic access to sufficient, safe and nutritious food to meet their dietary needs and food preferences for an active and healthy life'. FAO, *World Food Summit - Plan of Action* (WFS 96/3, November 1996); see also Schwartz and Harper, above n 279, at 846.
[500] For example; the 2006 World Trade Report considers that holding stocks and trading with a diversity of suppliers probably is a more efficient strategy than subsidizing domestic production. World Trade Report 2006, above n 9, at 104; see also World Bank, Global Economic Prospects 2008, above n 253, at 124-125.
[501] Other elements explaining why it does not properly fit with other non-trade concerns is that food security is not a non-food item and that it is doubtful whether it has public good characteristics because a functioning market exists. D. Vanzetti and E. Wynen, 'The "Multifunctionality" of Agriculture and its Implications for Policy', in Merlinda D. Ingco, John D. Nash (eds), *Agriculture and the WTO: creating a Trading System for Development* (Washington DC: World Bank, 2004), 387 pp., 167-177, at 174-175.
[502] OECD, above n 493, at 47-48, 74.
[503] Vanzetti and Wynen, above n 501, at 168. See below Part II, Chapter 6, Section 6.2.2.

other hand, WTO Members such as the US and Australia have questioned the link between commodity production levels and the achievement of non-trade concerns.[504] For instance, flood mitigation is articulated by the Japanese government as a justification for subsidies to paddy rice production. But opponents have argued that other methods (e.g., dams) might be equally effective without stimulating agricultural production.[505]

3.3. REDISTRIBUTION AND REGIONAL DEVELOPMENT

Subsidies are regularly used as governmental instruments to redistribute income among regions as this is seen as imperative not only from an equity point of view but equally to lower potential social or political tensions between regions.[506] Such in-country disparities in income levels might be the result of differences in resources (e.g., natural resource) between regions. Alternatively, the mere presence of external economies of scale could explain why production might cluster in some regions and not in others. Whereas from an economic viewpoint governments might rather opt for stimulating further clustering, they could choose for subsidizing production in backward regions for redistributive reasons. Thus, subsidies on these latter grounds do not aim at correcting a certain market failure, but at altering the market outcome.[507] Redistribution is preferably reached through domestic subsidies rather than through export subsidies and/or import duties, as the latter two options negatively affect domestic consumers.[508] Still, under the assumption of complete and perfectly competitive markets, such subsidies stimulating production in backward regions might not be first-best instruments to achieve redistribution.[509] Indeed, redistribution of income could in principle be better obtained by using so-called lump-sum taxes and transfers, which by definition do not affect the efficient allocation of resources (no deadweight losses). In that case, income would simply be transferred from inhabitants of advanced regions to backward regions through a system of direct taxes on high incomes and transfers (i.e., not conditioned on any use) to low incomes.[510] Of course, transfers are not costless as they could have an adverse effect on incentives and incur an administrative cost.[511] Moreover, if regional labor distribution generates external benefits that are not reflected in wages (e.g., reducing

[504] They observe how the multifunctionality argument is supported by those countries having the largest amount of production supporting domestic support, which might suggest that these non-trade concerns are simply used as pretext for legitimizing protection. For an overview of the different positions and arguments, see Vanzetti and Wynen, above n 501, at 168.
[505] Vanzetti and Wynen, above n 501, at 168.
[506] Different reasons explaining why societies redistribute income are listed in World Trade Report 2006, above n 9, at 89-90 and 95.
[507] World Trade Report 2006, above n 9, at 107.
[508] Meade, above n 31, at 314.
[509] IMF, *Fuel and Food Price Subsidies: Issues and Reform Options* (Washington DC: IMF, September, 2008), 55 pp., at 35.
[510] For instance, this was already described by Meade, above n 31, at 314.
[511] World Trade Report 2006, above n 9, at 90.

congestion in cities), stimulating employment (wage subsidy) or production in backward regions could become appropriate.[512]

3.4. POLITICAL ECONOMY

The political-economy or public choice literature does not start from the assumption that decision-makers aim at maximizing economic (or non-economic) welfare of their constituencies but instead assumes that politicians aim at maximizing their *own* welfare (self-interest), which is often modeled in terms of maximizing their chances on (re-)election. The outcome of the decision-making process, for example on offering subsidies or imposing CVDs, thus depends on its effect in the political 'marketplace'.[513] In the standard model, this 'marketplace' is constructed as a democracy, in which politicians have to obtain the support of the majority to be elected. Under simple majority voting, the outcome of a decision depends on whether it has a positive or negative effect on the median voter. Subsidies benefit its recipients, while other voters merely bear a cost in the form of taxes raised to pay for the subsidy. Here, a subsidy would only be offered if the median voter is one of those beneficiaries. Hence, this model would predict that sector-specific subsidies are unlikely to be offered as only few benefit.[514] Similarly, the imposition of CVDs or any other tariff would be improbable, because only a limited group of import-competing producers generally benefits at the expense of a large group of consumers. In reality, however, the opposite situation seems to happen more frequently: the more benefits are concentrated and the more costs are diffused, the more likely that promotion or protection is given. This insight was offered and modeled by Olson who explained the conditions for the emergence of 'special interest groups'. Promotion (e.g., subsidies) or protection (e.g., CVDs) might offer large individual gains to individual producers, and thus give these beneficiaries an incentive to lobby for such an outcome. Their relatively small number also makes it easy to efficiently organize theirselves so as to overcome free rider problems and collectively lobby for influence.[515] These 'special interest groups' thus manage to devote time and resources (e.g., campaign contributions) to influence the decision-making process in a way that makes them better off. Complementary, politicians are willing to accept their contributions and thus take their interests into account, as it improves their chances on re-election.[516] On the other hand, the costs of subsidies and CVDs on respectively taxpayers and consumers are highly diffuse,

[512] Here again, a market failure would be present, which could be targeted directly by a wage subsidy.
[513] Sykes, above n 137, at 275.
[514] World Trade Report 2006, above n 9, at 64.
[515] The incentive upon each individual firm might already be sufficient to lobby for influence. Hence, free-rider problems are unlikely to impede lobbying efforts. Sykes, above n 137, at 275.
[516] Because self-interest is often modelled as maximizing the chances on (re-)election, the contributions made by special interest groups are often assumed to take the form of campaign contributions. Likewise, these contributions could simply be seen as enriching the decision-makers in question.

implying that each individual has not much to gain if those measures are not adopted and that organizing themselves to this end is much more difficult (e.g., free rider problem).

Grossman and Helpman constructed a formal model[517] in which (i) 'special interest groups' offer campaign contributions to politicians running for re-election so as to influence their choice of trade policy (e.g., tariffs and export subsidies) and (ii) politicians aim at maximizing their chances on re-election (self-interest), which depends on the amount of such contributions as well as on the overall economic welfare generated by their trade policy.[518] Under the small country hypothesis, free trade would maximize overall welfare. Yet, because campaign contributions also influence politicians' behavior, the equilibrium in the Grossman and Helpman model deviates from this welfare optimum: tariffs and export subsidies are offered to all sectors that are organized as special interest groups, implying higher prices on those products in the domestic market than under the free trade situation.[519]

Two interesting extensions of the model are further presented. First, different special interest groups might have opposite interests as producers. In particular, downstream producers who use intermediate inputs are very often organized as a special interest group and would oppose to any import barrier or export promotion on this product as it pushes the price upwards. Facing opposition of downstream producers, producers of intermediate goods are less likely to be rewarded with import protection or export promotion than producers of final goods. Second, the introduction of a large country assumption not only alters the (unilateral) equilibrium of the country in question but could also result in cooperation (trade negotiations) with third countries, because this trade policy has an impact on those third countries. Under the non-cooperative equilibrium ('trade war'), producers are more likely to get tariff protection (e.g., CVDs) but are less likely to receive export subsidies than under the small country hypothesis, given large countries' overall welfare could be maximized by imposing an optimal tariff and/or export tax.[520] Grossman and Helpman show why politicians

[517] G. M. Grossman and E. Helpman, 'Protection for Sale', 84:4 *The American Economic Review* (September, 1994), 833-850. A detailed example of such political-economy forces is given by Gardner in an article explaining the rationale for export subsidies for wheat production in the US (1985-1993). B. L. Gardner, The Political Economy of US Export Subsidies for Wheat', in A. O. Krueger, *The Political Economy of American Trade Policy* (Chicago: The University of Chicago Press, 1996), 291-331.

[518] To be clear, politicians' (potential) concern for overall welfare thus only arises because of self-interest as it might increase their chances on re-election.

[519] In the equilibrium, the joint welfare of politicians (which is a function of campaign contributions and overall welfare) and special interest groups is maximized. Obviously, the smaller the weight given to overall welfare by politicians, the larger the levels of tariffs and export subsidies. Grossman and Helpman, above n 517, at 833-850.

[520] The 'concern' for overall welfare pushes the government towards an export tax, whereas export industries bid for export subsidies. Hence, the equilibrium might be either an export tax or an export subsidy (or free trade). Compared to the small country situation, export industries bidding for export subsidies not only compete with other producers who have an opposite interest (e.g., downstream producers) but also face opposition of the negative effect on overall welfare.

motivated by self-interest would nonetheless gain from concluding a trade agreement ('trade talk').[521,522]

In sum, the political-economy literature explains why countries would be willing to offer subsidies or CVDs, even though this would not benefit their overall welfare. Subsidies are hereby not offered to correct market failures, and thus to improve overall welfare, but because its beneficiaries (i.e., special interest groups) are successful in lobbying. In political-economy terms, an export subsidy may very well be perceived as a gain to an exporting country (e.g., rewarded by exporters) and a cost to an importing country (e.g., harm to import-competing industries). Here, a 'government failure' is present, not because the government lacks the administrative capacity or information to efficiently correct market failures, but because it is captured by special interest groups.[523] Similarly, CVDs, as mostly welfare-reducing instruments from the perspective of overall welfare, are imposed on demand of the small group of producers that hurt by subsidized imports.[524,525]

Importantly, political-economy reasons might thus help explain why subsidies and CVDs *are* installed (positive theory) as well as regulated but, contrary to economic theory, do not offer an argument why they *should be* supported (normative theory).[526] To the contrary, if governments are mainly driven by political-economy reasons when offering subsidies and

[521] Compared to the non-cooperative equilibrium, politicians' benefits that result from concluding an agreement flow from the extra market access generated in third countries and from the reduction in government support for foreign firms competing in the import market for which they will be rewarded by export industries and import-competing industries respectively. G. M. Grossman and E. Helpman, 'Trade Wars and Trade Talks', *NBER Working Paper Series* No 4280 (February, 1993), 40 pp.

[522] Next to political-economy motivations, Ethier criticizes this model because it incorporates terms of trade motivations on the part of the government. The central premise of the 'Received Theory' elaborated in this model (as also adopted by Bagwell and Staiger) is that trade agreements are concluded because, at least to some degree, governments are concerned with terms of trade considerations. According to Ethier, such models, however, do not correspond with reality. For example, the Grossman and Helpman model would suggest that, under certain conditions (see above n 520), countries would impose an export tax to manipulate terms of trade (non-cooperative equilibrium). This model would thus predict that countries would multilaterally agree to limit such terms of trade manipulations (cooperative equilibrium). In reality, however, countries almost never impose export taxes (and certainly not for terms of trade reasons). Moreover, these taxes are in principle not restricted under the WTO unless these are bound in a Member's Schedule. As Ethier argues, the Grossman and Helpman model only fits with reality if political-economy motivations completely dominate terms of trade motivations. See W. J. Ethier, 'The Theory of Trade Policy and Trade Agreements: A Critique', 23 *European Journal of Political Economy* (2007), 605-623.

[523] A variant is that governments do aim at maximizing global welfare but to this end have to rely on special interest groups for information and thus anyway fail to reach the welfare optimum. Baylis, above n 44, at 351-352.

[524] The fact that CVDs react against actions of foreign governments (i.e., subsidization) might partly explain why anti-dumping duties (reacting against behaviour of foreign firms) are nonetheless more popular. World Trade Report 2009, above n 44, at xx.

[525] The political-economy rationale for CVDs could be linked to the 'entitlement model' insofar the latter is used as a positive theory (see below Part IV, Chapter 4).

[526] See also W. J. Ethier and A. L. Hillman, 'Introduction', in W. J. Ethier and A. L. Hillman (eds), *The WTO and the Political Economy of Trade Policy – Part I* (Cheltenham: Edward Elgar, 2008), 599 pp., xi-xviii, at xiii.

CVDs, international disciplines restricting their use and thus ‘tying the hands of governments’ would likely be welfare-improving.

PART II

LEGAL DISCIPLINES ON SUBSIDIZATION AND THE IMPOSITION OF COUNTERVAILING MEASURES

INTRODUCTION

The legal analysis on the multilateral disciplines on subsidies affecting trade in goods is structured around six chapters. After an overview of the legal and historical context (Chapter 1), the object and purpose of the SCM Agreement is clarified (Chapter 2) and the various aspects of the definition of a specific subsidy included in the SCM Agreement are explained (Chapter 3). When a specific subsidy is deemed to exist under the SCM Agreement, a traffic light metaphor can be used to categorize subsidies (Chapter 4). Some types of subsidies are prohibited (red light), whereas all other specific subsidies are allowed as long as they do not cause adverse effects to other WTO Members (amber light). At present, no type of subsidy gets *ipso facto* the green light under the SCM Agreement. Later in this part, the way WTO Members may respond to subsidies provided by other WTO Members is explored (Chapter 5). WTO Members can challenge red light and amber light subsidies before the WTO-adjudicating bodies (multilateral remedy), or in case subsidized imports cause injury to their domestic industry, they can alternatively opt for the imposition of CVDs (unilateral remedy). However, not all WTO Members and types of subsidies are treated equally. Indeed, in the final chapter of this Part (Chapter 6), the special and differential treatment provided to developing countries is studied before the focus is shifted to the different treatment of agricultural subsidies under the Agreement on Agriculture.

1. HISTORICAL OVERVIEW

This general historical overview serves a double purpose. First, tracing back the origins of the current disciplines is meaningful not only for interpreting their specific meaning but also for grasping the basic structure of the SCM Agreement and Agreement on Agriculture. Second, this overview aims at giving an insight in the reasons why countries have agreed to gradually strengthen multilateral disciplines on subsidization and the imposition of countervailing measures, which is important for understanding the dynamism of current and future negotiations in this domain.

1.1. GATT 1947

Already during World War II, it was broadly recognized that enhanced international economic cooperation was needed to prevent beggar-thy-neighbour policies, such as competitive devaluations, import restrictions, and export subsidies, that had plunged international trade and turned the international economy into the Great Depression (1930s), contributing to the circumstances leading to World War II.[527] Next to the IMF and World Bank[528], resulting from the Bretton Woods Conference (1944), an International Trade Organization (ITO) had to become the third pillar of this international economic architecture.[529] The US, as main driving force to set up this third pillar, introduced the text which served as the basis for the ITO negotiations (1946-1948),[530] though its *Suggested Charter* had *de facto* been drafted in close cooperation with the UK. Regarding subsidies, both countries had defended 'diametrically opposed'[531] views: the US wished to phase out domestic (agriculture) subsidies but preserve export subsidies, whereas the UK pushed for the opposite. As a compromise somewhat more in line with the UK's position,[532] the Suggested

[527] According to some economists like Krugman, World War II not only indirectly resulted from the economic recession but, at the same time, also halted the recession in the US by generating massive government spending, though this interpretation has also been challenged. See P. Krugman, *The Return of Depression Economics and the Crisis of 2008* (New York: W.W. Norton & Company, 2009), 207 pp., at 71. For an overview of this discussion, see A. Spilimbergo, S. Symansky, O. Blanchard, and C. Cottarelli, 'Fiscal Policy for the Crisis', *IMF Staff Position Note* (29 December 2008), 37 pp., at 23.

[528] More precisely, one pillar of the World Bank, the International Bank for Reconstruction and Development, was set up.

[529] Irwin, Mavroidis and Sykes nuance that there is little evidence that the ITO was supposed to become an equal partner but agree that all three institutions at least shared the same goal to help promote international economic cooperation. D. A. Irwin, P. C. Mavroidis, and A. O. Sykes, *The Genesis of GATT* (Cambridge: Cambridge University Press, 2008), 314 pp., at 99.

[530] In full: Suggested Charter for an International Trade Organization of the United Nations (September 1946).

[531] Irwin, Mavroidis, and Sykes, above n 529, at 70.

[532] According to one British negotiator, the Americans 'quarreled so much among themselves (State Department versus Agriculture Department) that by invoking one or other of the antagonists, it was

Charter stipulated next to procedural requirements on all trade affecting subsidies also a prohibition on export subsidies (over a three year period), except under circumstances of burdensome world surplus in a product.[533] Such bifurcation between disciplines on domestic and export subsidies appeared pivotal to other countries during the ITO negotiations because export subsidies were considered more likely to distort trade (as the Great Depression had demonstrated[534]) and the flexibility on domestic subsidies preserved their role as a tool to spur industrialization, though developing countries already underlined that in practice it was only an affordable tool to richer countries.[535] In the end, the *Havana Charter* disciplined subsidies largely along the same lines as initially suggested by the US and UK:[536] all trade affecting subsidies had to be notified and their limitation discussed if causing serious prejudice to other Members and export subsidies were prohibited (over a two year period),[537] with exception of export subsidies on primary commodities, which were in essence only prohibited if leading to a 'more than equitable share of world trade'.[538] However, due to the non-approval of the Havana Charter by the US Senate, the Havana Charter and by consequence the ITO never saw the light of day and only the *General Agreement on Tariffs and Trade* (GATT 1947 or GATT) came into force.[539] Because negotiated tariff schedules could not easily be postponed until final approval on ITO, it had indeed been decided in the course of the ITO negotiations to detach and already provisionally apply the core disciplines on tariff reductions in a separate document, the GATT. Yet, even though some countries had favoured their inclusion[540], the

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always possible to have a majority for our views'. As cited in Irwin, Mavroidis, and Sykes, above n 529, at 70, footnote 90.

[533] Although the carve out did not explicitly single out primary products, these were intended to be prime candidates to be in surplus. If cooperation among Members to deal with surpluses (e.g., by signing inter-governmental commodity agreements) failed, export subsidies could be offered provided that previous market shares were respected (Article 25 of the Suggested Charter).

[534] R. E. Baldwin, 'Imposing Multilateral Discipline on Administered Protection', in A. O. Krueger (ed), *The WTO as an International Organization* (Chicago: The University of Chicago Press, 1998), 297-327, at 86.

[535] London Draft (E/PC/T/33), at 8, 16, 17, 32. The US State Department had reported the same observation when discussing a draft of its Suggested Charter with developing countries:

> 'These countries, deeply concerned with the problem of industrialization and full employment, want to use restrictive measures to protect their infant industries. In general, they remain unimpressed with our contention that subsidies offer the least objectionable method for this purpose. They point out that, while tariffs and subsidies both amount to charges on their economies, the very real difficulties in raising the revenue to pay subsidies make the latter impractical for them'.

As cited in Irwin, Mavroidis, and Sykes, above n 529, at 76, 104-105.

[536] For a detailed comparison, see *Note by the Secretariat* (AG/W/4, 12 September 1983), at 4-16.

[537] Articles 25, 26 of the Havana Charter.

[538] This follows from a combined reading of Articles 26, 27:3, and 28:1 of the Havana Charter. See also above n 533.

[539] GATT 1947 came into effect on 1 January 1948 by virtue of the Protocol on Provisional Application.

[540] Brazil, Chile, Cuba, and China. *Second Session of the Preparatory Committee of the United Nations Conference on Trade and Employment* (E/PC/T/TAC/PV/11, 5 September 1947), at 13-18; *Report of Working Party No. 3 on Modifications to the General Agreement* (GATT/CP.2/22, 27 August 1948).

substantive disciplines on export subsidies were, for several reasons, not transferred to the GATT.[541] First, export subsidy disciplines, which related to export treatment, did not fit into the GATT's focus on import treatment.[542] In the words of the US representative, export subsidy disciplines 'got into the realms of competition between countries in markets of a third country', an area not covered by the GATT.[543] Second, the US executive branch did not have the mandate to agree upon the GATT without approval of Congress if a prohibition on export subsidies was also inscribed.[544] Third, inclusion in the GATT was considered not highly relevant as it was foreseen that the substantive disciplines on export subsidies would anyway enter into force together with the ITO.[545] On the other hand, the US successfully suggested including the *procedural disciplines* on trade affecting subsidies into the GATT as it recognized that domestic subsidies could have a limiting effect on imports and thus erode tariff concessions.[546]

541 But, in light of Article XXIX of the GATT, the Contracting Parties undertook to apply the principles of the Havana Charter relating to export subsidies to the full extent of their executive authority (*Report of Working Party No. 3 on Modifications to the General Agreement* (GATT/CP.2/22, 27 August 1948), at 4).

542 *Second Session of the Preparatory Committee of the United Nations Conference on Trade and Employment* (E/PC/T/TAC/PV/11, 5 September 1949), at 13. Irwin, Mavroidis, and Sykes argued that, given that the GATT aimed at giving effect to tariff concessions, it was only required to ensure that subsidies could not circumvent tariff reductions, which was dealt with under the non-violation complaint (see below), and not to *prohibit* export subsidies as well (Irwin, Mavroidis, and Sykes, above n 529, at 113). Although their reasoning somewhat resembles the argument made in the body text, the motivation to exclude the prohibition on export subsidies from the GATT seemed not that a *prohibition* would be too far reaching to preserve tariff concessions but that substantive disciplines on *export* subsidies simply did not fit in the GATT scope as the latter dealt with the import realm. A non-violation complaint under Article XXIII of the GATT is useful to discipline tariff concession eroding domestic subsidies but not export subsidies as their effect occurs in third countries (see also below Part IV, Chapter 2). See also G. C. Hufbauer, J. S. Erb, *Subsidies in International Trade* (Washington DC: Institute for International Economics, 1984), 283 pp., at 33; R. E. Hudec, 'Regulation of Domestic Subsidies Under the MTN Subsidies Code', in D. Wallace, F. J. Loftus and V. Z. Krikorian (eds), *Interface Three: Legal Treatment of Domestic Subsidies* (Washington DC: The International Law Institute, 1984), 1-18.

543 *Second Session of the Preparatory Committee of the United Nations Conference on Trade and Employment* (E/PC/T/TAC/PV/11, 5 September 1947), at 14-15.

544 *Summary Record of Second Meeting* (E/PC/T/C.6/46, 6 February 1947), at 2. See also J.H. Jackson, *World Trade and the Law of GATT – A Legal Analysis of the General Agreement on Tariffs and Trade* (Indianapolis: The Bobbs-Merrill Company, 1969), 948 pp., at 44, 370.

545 *Second Session of the Preparatory Committee of the United Nations Conference on Trade and Employment* (E/PC/T/TAC/PV/11, 5 September 1947), at 16-17; Jackson, above n 544, at 370.

546 *Summary Record of Second Meeting* (E/PC/T/C.6/46, 6 February 1947), at 2; *Second Session of the Preparatory Committee of the United Nations Conference on Trade and Employment* (E/PC/T/TAC/PV/11, 5 September 1947), at 14. To be precise, the text of Article XVI of the GATT is identical to Article XIV of the New York draft (E/PC/T/C.6/85, 15 February 1947). On demand of the US, this provision was further strengthened during the negotiations on the Havana Charter. As a result, the corresponding provision of the Havana Charter (Article 25) differs from Article XVI:1 of the GATT. Yet, these modifications were not substituted in the GATT 1947 because they were considered to be not of a 'substantial nature'. Indeed, the working party agreed that the modifications included in the Havana Charter could be read into Article XVI: (i) the phrase 'increased exports' in Article XVI was intended to include the concept of maintaining exports at a level higher than would otherwise exist in the absence of the subsidy; (ii) consultation shall proceed upon request of a contracting party when it

As a result, the original GATT was very lenient toward subsidies provided by its Contracting Parties. *Article XVI of the GATT* merely imposed the *procedural* disciplines to notify subsidies that were export stimulating or import reducing and, upon request, to discuss the limitation of these subsidies if they caused or threatened to cause serious prejudice to other Contracting Parties.[547] This should be read together with Article III:8(b) of the GATT, which exempts the payment of subsidies exclusively to domestic producers from the national treatment discipline.[548] On the other hand, other Contracting Parties preserved two options to react against such foreign subsidization affecting respectively their import- or export-competing industry.[549]

First, Contracting Parties whose industry was injured by subsidized imports were allowed to 'countervail', i.e., to impose countervailing duties, up to the amount of the subsidy (*Article VI:3 of the GATT*) but the concept of 'subsidy' itself was left undefined.[550] This right was made subject to the determination by the countervailing country that the subsidy caused (or threatened to cause) material injury to its domestic industry. However, the exact procedural and substantive obligations were not spelled out.[551] These loose disciplines on CVDs were modeled on US laws.[552] In a way, the possibility to impose CVDs helped to safeguard tariff negotiations as it ensured that Contracting Parties could effectively protect their domestic industry up to their bound level without being eroded by foreign subsidization.[553]

Second, Contracting Parties could also bring a non-violation complaint (NVC) under *Article XXIII(b) of the GATT*, claiming that subsidization had nullified the benefits of tariff concessions (or of other GATT obligations) to their exporters. Negotiators had indeed been aware of the equivalence between a tariff and a production subsidy combined with a consumption tax, implying that tariff concessions could be undone by a combination of both instruments.[554]

However, NVCs, securing negotiated market access in the subsidizing country, as well as CVDs, securing 'fair' competition in the home country, were ineffective instruments to

considers that prejudice is caused or threatened and would not require a prior international determination. See *Note by the Secretariat* (AG/W/4, 12 September 1983), at 7, 8, 10, 11, 15, 16.

[547] The original Article XVI was thus limited to paragraph 1 of the current Article XVI of the GATT. All Contracting Parties were bound by this obligation. For an overview of the drafting history of Article XVI of the GATT 1994, see *Note by the Secretariat* (AG/W/4, 12 September 1983).

[548] For the exact scope of this exemption, see below Part II, Chapter 3, Section 3.1.1.3.

[549] Moreover, the escape clause in Article XIX of the GATT (later elaborated in the Safeguards Agreement) could also be relevant to respond to subsidies resulting in increased imports that cause or threaten to cause serious injury to domestic producers. See Jackson, above n 544, at 377-378.

[550] See also Article II:2(b) of the GATT. The UK had thus unsuccessfully advocated during the GATT negotiations that all CVDs and anti-dumping duties should be prohibited. See *Committee II - Draft report of the technical Sub-Committee.* (E/PC/T/C.II/54, 16 November 1946), at 16.

[551] See Articles VI:3, VI:4, VI:5, and VI:6 of the GATT.

[552] For an excellent overview of the evolution in US CVDs law, see Baldwin, above n 534, at 303.

[553] See below Part IV, Chapter 4.

[554] See Irwin, Mavroidis, and Sykes, above n 529, at 172. See above Part I, Chapter 1.

protect exporters' interests in third markets.[555] If Contracting Parties aimed at securing these interests (for whatever reasons, see Part I), they had no other option than to respond by (export) subsidizing their exporters.[556] Already in the next decade, the potential of such destructive subsidy competition would prove to be an important impetus to launch negotiations on substantive disciplines on export subsidies in both the GATT and the Organization for European Economic Cooperation (OEEC/OECD).

1.2. THE 1954-1955 REVIEW SESSION AND THE 1960 DECLARATION

During the 1954-1955 Review Session of the GATT, developed countries generally agreed on the principle of prohibiting export subsidies, at least for non-primary products.[557] Even some developing countries such as India did not principally oppose such prohibition (certainly not on developed countries[558]) as they acknowledged that they would never win any export subsidy competition with their limited financial resources.[559] On the other hand, many countries, even several European countries such as France, opposed – but finally gave way to – the US' obstinate position to preserve important leeway for export subsidies on primary products.[560]

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[555] There was only one limited exception inscribed. Article VI:6(b) of the GATT 1947 allows a country (Country A) to impose CVDs (or anti-dumping duties) on the importation of any product for the purpose of offsetting subsidization (or dumping) by another country (Country C) (or anti-dumping) which caused injury to an industry of another Contracting Party (Country B) also exporting to the importing country (Country A). However, only a waiver by Contracting Parties could open the door for such CVDs protecting trading interests of trading partners. The 1954-1955 amendment made this option somewhat more flexible with regard to CVDs (see below n 562). This provision offers a limited option for countries (in this case, Country A) whose own domestic industry is not injured by subsidized imports (e.g., lack of domestic industry) to impose CVDs so as to protect the interests in its territory of exporters from a trading partner (in this case, Country B). Next to the legal hurdle under Article VI:6 (see also below n 562), the fact that subsidized imports might very likely be welfare improving for this importing country (in this case, Country A) explains why this option is not used in practice.

[556] See, for example, the statement of India in *Summary Record of the Seventeenth Meeting* (SR.9/17, 23 November 1954), at 17.

[557] For an overview of all different positions, see *Note by the Secretariat* (AG/W/4, 12 September 1983), at 17-20.

[558] See below n 571.

[559] This was India's response to Brazil's plea for the right (and even duty) to offer export subsidies under certain circumstances. See *Summary Record of the Twenty-Third Meeting* (SR.9/23, 22 December 1954); *Summary Record of the Twenty-Fourth Meeting* (SR.9/24, 22 December 1954).

[560] The US even obtained an open-ended waiver in 1955 for its domestic agricultural program. For the US proposal, see *Article XVI – Subsidies - Proposed Draft Presented by the United States Delegation* (W.9/103, 15 December 1994). The UK's proposal also included more leeway for primary products but less extensive as under the US proposal and, contrary to the US proposal, also included a list of 'artificially incentives to exports' (e.g., export credit guarantees at non-commercial terms), which were covered under the prohibition on export subsidies for non-primary goods (*Subsidies - Draft Submitted by the United Kingdom Delegation as a Basis for Discussion - Article XVI* (W.9/104, 16 December 1954)). Denmark tabled the most stringent proposal as it suggested to simply ban all export subsidies after a transition period (*Proposals by the Danish Government* (L/273, 9 November 1954)). See also *Canadian Proposal for Amendment to Article XVI* (W.9/119, 17 December 1954). For discussions, see *Summary Record of the Forty-First Meeting* (SR.9/41, 15 March 1955); *Summary Record of the*

In the end, Contracting Parties agreed to facilitate challenging domestic subsidies on the basis of the NVC[561] and, more fundamentally, included the first specific substantive obligations on export subsidies in Article XVI GATT. [562] These substantive disciplines introduced in a new *Section B of Article XVI of the GATT* were largely in line with the subsidy disciplines already foreseen in the Havana Charter, though Jackson revealed that the differential treatment of primary products had even become stronger.[563]

Regarding primary products,[564] paragraph 3 of Article XVI GATT only provided for an obligation to 'seek to avoid' the use of export subsidies and, if Contracting Parties did grant a subsidy that had the effect of increasing exports, it was made subject to a highly ambiguous trade effect test insisted upon by the US:[565] it could not be used in a way that resulted in 'more than an equitable share of world export trade in that product'.[566]

Twenty-Fourth Meeting (SR.9/24, 22 December 1954); *Summary Record of the Twenty-Third Meeting* (SR.9/23, 22 December 1954); *Progress Report by the Chairman of Working Party III* (W.9/122, 18 December 1954); *Progress Report of the Chairman of Sub-Group III-A on Subsidies* (W.9/102, 15 December 1954); *Summary Record of the Seventeenth Meeting* (SR.9/17, 23 November 1954).

[561] It was also observed that Contracting Parties had the option to negotiate on subsidies which might affect tariff concessions and to schedule the results of these negotiations. See *Report of Review Working Party III on Barriers to Trade other than Restrictions or Tariffs* (L/334, 1 March 1955), paras 13-14.

[562] With regard to CVDs action, paragraph 6 of Article VI was amended. The meaning of 'injury' was clarified and the circumstances whereby CVDs may be used when injury is occurring in another Contracting Party were expanded (see above n 555). Interestingly, the latter amendment was initiated by New Zealand and Australia because they considered it, at that time, 'unlikely that very strict rules will apply to the use of export subsidies' (*Proposal by Australian and New Zealand Delegations, Amendments to Paragraph 6 of Article VI* (W.9/214, 21 February 1955); a more far reaching proposal by New Zealand was not adopted (see L/270/Add.1, 18 November 1954)). Whereas under the original GATT 1947 Contracting Parties had the discretionary power to decide on such a waiver, Article VI:6(b) was amended in a way that Contracting Parties *should* provide a waiver in case they find material injury caused by subsidization (Article VI:(b), second sentence). Moreover, Article VI:6(c) was added, which allows 'in exceptional circumstances' the imposition of CVDs without prior approval but these have to be withdrawn immediately if Contracting Parties disapprove afterwards. Yet, Jackson observed back in the 1969 that no waiver has ever been requested. See also *Final Report of Sub-Group III-A* (W.9/220, 22 February 1955), paras 12, 14; *Report of Review Working Party III on Barriers to Trade other than Restrictions or Tariffs* (L/334, 1 March 1955), para 13.

[563] Jackson, above n 544, at 371.

[564] For the purpose of Article XVI of the GATT, primary products are defined as 'any product of farm, forest or fishery, or any mineral, in its natural form or which has undergone such processing as is customarily required to prepare it for marketing in substantial volume in international trade' (para 2 of Ad Article XVI:Section B of the GATT).

[565] See *Progress Report of the Chairman of Sub-Group III-A on Subsidies* (W.9/102, 15 December 1954), at 3.

[566] All Contracting Parties that accepted the 1955 amendment to Parts II and III of the GATT were subject to this obligation. See Jackson, above n 544, at 376. Although firmly criticized by other countries, the reference to the *world* market (instead of individual markets) under this equitable market share standard was pushed through by the US. To determine the 'equitable share' of a Contracting Party, account would be taken of the shares in the product during a previous representative period and 'any specific factor' affecting trade in the product (Article XVI:3 of the GATT). Yet, on request of developing countries, it was clarified that the fact that a Contracting Party had not exported the product in question during the previous representative period would not in itself preclude that party from establishing its right to obtain a share of the trade in the product concerned (para 1 of Ad Article XVI:3

Regarding non-primary products, on the other hand, Contracting Parties had, from 1958 or 'the earliest practicable date thereafter', to cease to grant export subsidies when they resulted in a sale at a price for export lower than that for the domestic market (bi-level pricing test) (Article XVI:4 of the GATT).[567] Only in 1960, Contracting Parties could agree on a Declaration Giving Effect to the Provisions of Article XVI:4 (*1960 Declaration*), which elaborated a non-exhaustive list of export subsidies on non-primary goods.[568] A general definition of the term 'subsidy' was thus still lacking but an illustrative list of prohibited export subsidies was agreed upon. This list was in fact based on a previous list of prohibited 'aids to export' drafted in the OEEC[569], which was transferred to the GATT when the OEEC transformed into the OECD in 1960. This transfer to the GATT was initiated by France so as to broaden its application also to non-OECD countries.[570] Yet, because of the difference in treatment between primary and non-primary goods as well as the wish to preserve policy space, all developing countries (except for Zimbabwe) as well as some developed countries (e.g., Australia) were unwilling to adopt the 1960 Declaration,[571] which was in the end only accepted by 17 Contracting Parties.[572]

In sum, the 1955 GATT amendment and 1960 Declaration formally introduced three types of bifurcation on subsidy disciplines that were already circulating during the GATT/ITO

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of the GATT). See also the exception for certain price stabilization schemes (para 2 of Ad Article XVI:3 of the GATT).

[567] The second sentence of Article XVI:4 of the GATT provided for a standstill obligation until the end of 1957. The expectancy was that the Contracting Parties would by that time have agreed to prohibit all non-primary export subsidies, but an agreement was only reached in 1960 with the 1960 Declaration, which was not accepted by all Contracting Parties. Therefore, the standstill obligation was extended several times (for some Contracting Parties up to the end of 1967). After 1967, Contracting Parties which did not accept the 1960 Declaration were not subject anymore to the standstill obligation.

[568] The 1960 Declaration became effective on 14 November 1962.

[569] Already in 1955, the OEEC, which was founded in 1947 to administer American and Canadian aid under the Marshall plan, succeeded to adopt an initial list of prohibited measures that were considered artificially aid to exporters and this list was further expanded in 1958. See also below Part III.

[570] See *Action by the Contracting Parties under Article XVI:4* (L/1260, 1 August 1960); *Summary record of the Third Meeting* (SR.17/3, 9 November 1960); *Action under Article XVI:4* (W.17/3, 2 November 1960); *Report of the working party on subsidies* (L/1381, November 1960); *Conference on the Reorganization of the O.E.E.C* (OECD/P/36, 25 October 1960).

[571] Jackson, above n 544, at 399. Although recognizing its limited financial resources, India observed that a ban would impede export subsidy competition with non-GATT countries and Pakistan was also unwilling to accept a prohibition at its stage of development. At the same time, India also recognized that a ban on export credit support at non-commercial terms for *developed* countries would make it difficult for less developed countries to import capital goods. See *Summary record of the Third Meeting* (SR.17/3, 9 November 1960), at 19-2 (see also below Part III). Hence, India's statements (see above n 559) reveal the ambiguous position of developing countries on export subsidy disciplines upon developed countries: their importers are at the losing end, while their exporters benefit. See also *Note by the Secretariat on the Meeting of June 1972* (Spec(72)61, 12 July 1972), para 10.

[572] Some of these countries, like the US, accepted this 1960 Declaration with reservations. A list of all 17 countries can be found in *Note by the Secretariat, Subsidies and Countervailing Measures* (MTN.GNG/NG10/W/4, 28 April 1987), at 75, footnote 1. Contracting Parties that did not accept the 1960 Declaration were thus not subject to the obligation to cease export subsidies on non-primary products (Article XVI:4, first sentence of the GATT).

negotiations. First, export subsidies are primarily targeted and only to a lesser extent domestic subsidies because the former are more likely to distort trade and the latter are also considered more important and legitimate as instruments to correct market failures. Second, as a result of the negotiating power of subsidizing developed countries, disciplines on agricultural subsidies[573] are also less severe when compared with disciplines on industrial subsidies.[574] Observe that, already in 1958, the Haberler Report had, nonetheless, come to the conclusion that agricultural subsidies and import protection hindered the development of developing countries.[575] Third, not all countries are subject to the same set of disciplines on subsidies as more policy space is given to developing countries to use export and domestic subsidies as tools to spur development. Over the next decades, all three types of asymmetries would gradually contract, though they are still present today.

1.3. THE TOKYO ROUND: THE SUBSIDIES CODE

The Tokyo Round negotiations (1973-1979) focused on the reduction of nontariff barriers to trade, such as subsidies. One of the most important agreements[576] emanating from this Round was the *Subsidies Code*, which was a plurilateral agreement, only accepted by 24 countries,[577] that entered into force in 1980.[578] In essence, the Subsidies Code constituted a compromise between the US, aiming at more stringent rules on the use of export and domestic subsidies for non-primary products, and the EC and other countries, aiming at disciplining the extensive

[573] To be precise, the Subsidies Code and GATT referred 'primary products' (see above n 564).
[574] In fact, a differential treatment of agricultural subsidies was already inscribed in the original GATT 1947 given that Article VI:7 of the GATT excludes the possibility to countervail certain agricultural subsidies for which a domestic stabilization scheme exists. See World Trade Report 2006, *Exploring the Links between Subsidies, Trade and the WTO* (Geneva: World Trade Organization, 2006), 223 pp., at 190.
[575] The Report concluded that agricultural protectionism in the industrial countries, which 'is the outcome of a complicated system of agricultural support schemes, whose object is stabilization as well as protection', should 'be moderated in exporting as well as importing countries, and should be combined with a shift towards giving economic aid to under-developed countries more and more in direct financial grants and less and less in the form of low-priced exports'. To minimize the adverse effect of agricultural protection, a shift from price support to deficiency payments was suggested. Moreover, developing countries' exports should receive easier access to developed countries' markets. See Report of a Panel of Experts, *Trends in International Trade* (Geneva: GATT, October 1958), 138 pp., paras 45, 49, and 341-350.
[576] According to several developed countries (*Minutes of the Meeting held on 8 May 1980* (SCM/M/3, 27 June 1980), at 3, 5, 6, 7).
[577] Some countries accepted this with exceptions or reservations. The full list of countries: Argentina, Australia, Austria, Brazil, Canada, Chile, Colombia, Egypt, the European Economic Community, Finland, Hong Kong, India, Indonesia, Israel, Japan, Korea, New Zealand, Norway, the Philippines, Sweden, Switzerland, Turkey, the United States, and Uruguay.
[578] In full: 'Agreement on interpretation and application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade'. See *Note by the Chairman, Subsidies/Countervailing Measures* (MTN/NTM/W/236, 5 April 1979).

use of CVDs by the US during the 1970s.[579] Since the end of the 1960s, increased competition from countries such as Japan in industrial sectors traditionally dominated by the US had put pressure upon the US to call for more stringent disciplines on what it called 'unfair' trade actions by trading partners and to unilaterally react against such practices by imposing CVDs and anti-dumping duties.[580,581] Furthermore, in response to the economic downturn in the 1970s resulting from the two oil crises, countries had embarked on extensive subsidization programmes, which, according to the GATT General-Director, led to trade based in some sectors (e.g., shipbuilding) on 'competitive subsidization' rather than on market forces.[582] Whereas during the 1940s and 1950s the US had been the main obstacle for concluding stricter disciplines on agricultural subsidies, this defensive role was taken over by the EC (e.g., France) during the Tokyo Round[583], resulting in no substantive progress on disciplining (export) subsidies on primary products in the Subsidies Code.[584]

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579 As expressed by the representative of the US, '(t)he fundamental negotiating position of the United States had been that they would give other countries a material injury test (…) in return for increased discipline over other countries' trade distorting subsidy practices'. See *Minutes of the Meeting held on 8 May 1980* (SCM/M/3, 27 June 1980), at 4, 8; J. Croome, *Reshaping the World Trading System – A History of the Uruguay Round*, 2nd ed (The Hague: Kluwer Law International, 1999), 360 pp., at 60; T. P. Stewart (ed), *The GATT Uruguay Round – A Negotiating History (1986–1992) – Volume 1* (Deventer: Kluwer, 1993), 1382 pp., at 817; R. C. Grey, 'Some Notes on Subsidies and the International Rules', in D. Wallace, F. J. Loftus and V. Z. Krikorian (eds), *Interface Three: Legal Treatment of Domestic Subsidies* (Washington DC: The International Law Institute, 1984), 61-70, at 61.

580 To be sure, already during the GATT negotiations had countries (e.g., UK) complained about low priced Japanese goods, which resulted in their view from low labor standards (i.e., social dumping), exchange manipulation (i.e., exchange dumping), and subsidies. See *Committee II - Summary record of technical Sub-Committee* (E/PC/T/C.II/48, 11 November 1946).

581 Next, the reduction in Cold War tensions also spurred the protectionist reflex given that the liberal agenda pursued before was legitimized on the basis of national security ground (i.e., resist expansion of Soviet influence). The anti-subsidy stance of the US was also influenced by the anti-distortion school, which questioned the usefulness of subsidies. See Baldwin, above n 534, at 304-305; Hufbauer and Erb, above n 542, at 22.

582 The GATT Director-General as cited in Stewart, above n 579, at 815.

583 Contrary to the negotiation positions under the 1954-1955 Review Session, it was France who, for instance, insisted upon the use of the world market as benchmark under the equitable share standard, while the US advocated the individual market approach (Hufbauer and Erb, above n 542, at 38). Whereas the US thus started to call for more efficiency, the EC Commission had only received a limited negotiating mandate from its Member States. The principles and mechanisms of its Common Agricultural Policy (CAP) could not be affected. Set up already in the 1950s and further extended during the 1960s, the CAP was based on the principles of common prices, common financing, and Community preferences, which were operated through a system of intervention (e.g., price support) and import protection. See J. A. McMahon, 'The Agreement on Agriculture', in P. F. J. Macrory, A. E. Appleton, and M. G. Plummer (eds), *The World Trade Organization: Legal, Economic and Political Analysis – Volume I* (New York: Springer, 2005), 187-229, at 191-196.

584 In line with Article XVI:3 of the GATT 1947, signatories agreed not to grant such subsidies 'in a manner which results in a more than equitable share of world export trade in such product' (Article 10.1 of the Subsidies Code) and only agreed on some clarifications on this benchmark in Article 10.2 of the Subsidies Code. Moreover, export subsidies on certain primary products to a particular market could not be offered in a manner 'which results in prices materially below those of other suppliers' to the same market (Article 10:3 of the Subsidies Code).

The compromise character on disciplines for non-primary products becomes clear from the Subsidies Code's provisions. On the one hand, in its so-called 'track I', the substantive and procedural rules on imposing CVDs were elaborated.[585] Importantly, the imposition of CVDs was made subject to a material injury test, which was lacking in the US CVDs procedure.[586] Alternatively, signatories could also opt for the multilateral remedy and apply the specific procedural rules on consultation, conciliation, and dispute settlement mapped out by the Subsidies Code.[587]

On the other hand, under 'track II', the Subsidies Code categorically prohibited the use of export subsidies on non-primary goods,[588] included a non-exhaustive list that built on the 1960 Declaration,[589] and introduced for the first time rather flexible substantive disciplines on the use of domestic subsidies.[590] These reflected the sensitive balancing act when disciplining domestic subsidies: on the one hand, signatories underlined that domestic subsidies are widely used as important instruments to promote social and economic policy objectives.[591] On the other hand, on the demand of the US, signatories also acknowledged that such subsidies could, at the same time, adversely affect the interests of other signatories, including when they displaced their exports in third country markets.[592] Recall hereby that trade-distorting effects of *domestic* subsidies in *third* countries could not be effectively addressed under the GATT instruments (unilateral CVDs, or multilateral NVCs[593]). Those subsidies granted 'with the aim of giving an advantage to certain enterprises' and which 'are normally granted either

[585] Articles 2–6 of the Subsidies Code.

[586] Article 6 of the Subsidies Code. Article VI:6(a) of the GATT already requires the determination of (threat of) material injury. However, the US CVDs law (1897) dated from before GATT 1947 and was thus grandfathered from Article VI of the GATT pursuant to the Protocol of Provisional Application. See *Minutes of the Meeting held on 8 May 1980* (SCM/M/3, 27 June 1980), at 4. But Baldwin indicated that 'material' was weakly defined under US law as 'harm which is not inconsequential, immaterial, or unimportant'. See Baldwin, above n 534, at 305.

[587] Articles 12, 13, 17, and 18 of the Subsidies Code. Signatories could opt between a claim under Article VI and/or XVI of the GATT or under the Subsidies Code in case the other party had also signed the Subsidies Code. See P. A. Clarke and G. N. Horlick, 'The Agreement on Subsidies and Countervailing Measures', in P. F. J. Macrory, A. E. Appleton, and M. G. Plummer (eds), *The World Trade Organization: Legal, Economic and Political Analysis – Volume I* (New York: Springer, 2005), 679-748, at 686.

[588] Although it purported merely to interpret Article XVI of the GATT, the Subsidies Code was thus more stringent because it did not adopt the bi-level pricing test. See J. H. Jackson, *The World Trading System: Law and Policy of International Economic Relations*, 2nd ed (Massachusetts: MIT Press, 1997), 441 pp., at 288–289.

[589] Articles 8 and 9 of the Subsidies Code and the Annex to the Subsidies Code.

[590] Articles 8 and 11 of the Subsidies Code.

[591] A non-exhaustive list of objectives was included (Article 11:2 of the Subsidies Code).

[592] Different types of adverse effects were thus distinguished. Next to injury to the domestic industry of another signatory and nullification or impairment, 'serious prejudice' to the industry of another signatory (Article 11:2 of the Subsidies Code) was included.

[593] The NVC claim was always applied with respect to tariff concessions, although it was strictly speaking not confined thereto. See also footnotes 24 and 26 of the Subsidies Code.

regionally or by sector' were targeted in particular.[594] In principle, countries were only obliged to seek to avoid causing such adverse effects.[595,596]

Raising the infant-industry argument,[597] developing countries also urged for more flexibility on both export and domestic subsidies.[598] As a result, the Subsidies Code explicitly recognized that subsidies were an integral part of their economic development programmes and that it therefore did not prevent developing countries 'to assist their industries, including those in the exporting sector'.[599] In particular, next to even more flexibility on domestic subsidies,[600] developing countries were not prevented from offering export subsidies but these could not be used in a manner that would cause serious prejudice to other signatories (trade effect test). Furthermore, they had to endeavour to enter into a commitment to reduce or eliminate export subsidies when these were inconsistent with their competitive and development needs (Article 14:5 of the Subsidies Code).[601]

An important incentive upon Contracting Parties to become a party to the plurilateral Subsidies Code was that this ensured Subsidies Code treatment by other signatories. Invoking the non-application provision[602], the US however refrained from offering such treatment to developing countries that did not enter into a commitment to reduce export subsidies (Article 14:5 of the Subsidies Code), which implied that their subsidized exports could still be countervailed by the US without causing 'material injury' even if they had become

[594] Article 11:3 of the Subsidies Code; see also Committee on Subsidies and Countervailing Measures, *Draft Guidelines for the Application of the Concept of Specificity in the Calculation of the Amount of a Subsidy other than an Export Subsidy* (SCM/W/89, 25 April 1985). This was the predecessor of the 'specificity' test of Article 2 of the SCM Agreement. Yet, contrary to the SCM Agreement, the Subsidies Code did not explicitly limit the imposition of CVDs to these types of 'specific' subsidies elaborated in Article 11:3 of the Subsidies Code (see Article 2 of the Subsidies Code).

[595] Article 11:2 of the Subsidies Code. The GATT Subsidies and Countervailing Measures Committee could review whether such adverse effects had occurred (Article 13 of the Subsidies Code).

[596] On the flexibility of the domestic subsidy disciplines, see also E. McGovern, *International Trade Regulation – GATT, The United States and the European Community*, 2nd ed (Exeter: Globefield Press, 1986), 629 pp., at 321; J. H. J. Bourgeois, 'The GATT Rules for Industrial Subsidies and Countervailing Duties and the New GATT Round – The Weather and the Seeds', in E-U Petersmann and M. Hilf (eds), *The New GATT Round of Multilateral Trade Negotiations* (Deventer: Kluwer Law and Taxation, 1988), 219-235, at 228-231.

[597] See above Part I, Chapter 2, Section 2.4. Developing countries also justified export subsidies as a means of offsetting other distortions (e.g., overvalued exchange rate, expensive domestically produced capital goods, high tariffs on imported capital goods). See Hufbauer and Erb, above n 542, at 41.

[598] The S&D treatment provisions of the first draft of the Subsidies Code proposed by developed countries (Canada, the EC, Japan, the Nordic countries, and the US; see MTN/NTM/W/168, 10 July 1978) were substantially altered after discussions with developing countries (MTN/NTM/W/210, 19 December 1978).

[599] Article 14:1, 14:2 of the Subsidies Code.

[600] Article 14:7 of the Subsidies Code.

[601] The disciplines on domestic subsidies (see above n 590) were also more flexible with respect to developing countries (see Article 14:7 of the Subsidies Code).

[602] Article 19:9 of the Subsidies Code.

signatory.[603] Developing countries (as well as the EC) objected the legality of this position,[604] which complicated and in some instances even prevented their accession to the Subsidies Code.[605] Apart from illustrating one of the many conflicts in the interpretation of key provisions of the Subsidies Code, this discussion shows the growing unease on the part of the US on what it called 'unfair' competition from producers of developing countries.

1.4. The Uruguay Round: The SCM Agreement and the Agreement on Agriculture

The economic recession in the early 1980s further increased the pressure on countries to support their domestic industry and agricultural sector. The Subsidies Code proved incapable of halting this subsidy reflex, leading to over-capacity in several sectors such as steel.[606] The GATT Subsidies and Countervailing Measures Committee, set up by the Subsidies Code,[607] was unable to resolve conflicts among parties because each of the parties could block the adoption of panel reports by the Committee and, more generally, the Committee could not agree on the interpretation or application of the Subsidies Code.[608] The Leutwiler Report, an independent expert report commissioned by the GATT Director-General, observed in the first half of the 1980s that 'subsidies have become the main source of unfair competition, and are at the root of the most serious and intractable trade disputes that have been brought before the GATT'.[609]

[603] See *Minutes of the Meeting held on 8 May 1980* (SCM/M/3, 27 June 1980), at 3-9; *Note by the Secretariat, Application of Articles 14:5 and 19:9 of the Agreement* (SCM/W/116, 5 September 1986); *Note by the Secretariat, Subsidies and Countervailing Measures* (MTN.GNG/NG10/W/4, 28 April 1987), at 87-93.
[604] In essence, they claimed that the commitments under Article 14:5 of the Subsidies Code were unilateral and autonomous. See *Minutes of the Meeting held on 8 May 1980* (SCM/M/3, 27 June 1980), at 5-10.
[605] For example, the US required full elimination of export subsidies from Columbia (*Minutes of the Meeting held on 17 November 1983* (SCM/M/19, 21 February 1984), at 9-11; *Minutes of the Meeting held on 8 May 1980* (SCM/M/3, 27 June 1980)). Contracting Parties were unable to solve this disagreement (*Minutes of the Meeting held on 26 April 1985* (SCM/M/28, 24 May 1985)).
[606] The actual average subsidy rates of OECD countries increased in the 1970s and thereafter stabilized or even declined in the late 1980s. At the same time, even a constant level of subsidization could be perceived as having larger effects in face of falling tariff barriers. See G. Hufbauer, 'A View of the Forest', in B. Balassa (ed), *Subsidies and Countervailing Measures – Critical Issues for the Uruguay Round* (Washington: The World Bank, 1989), 13-25, at 13; Stewart, above n 579, 809-812.
[607] See Articles 13, 16, and 18 of the Subsidies Code.
[608] The Committee was unable to adopt any GATT Panel Report or resolve any conflict before the completion of the Uruguay Round negotiations. Only in 1994 and 1995, three of the GATT Panel Reports that had been blocked previously were adopted by the Committee (see Stewart, above n 579, at 836; Clarke and Horlick, above n 587, at 687, footnote 35). For an overview of interpretation problems, see *Note by the Secretariat, Subsidies and Countervailing Measures* (MTN.GNG/NG10/W/4, 28 April 1987); *Note by the Secretariat, Problems in the Area of Subsidies and Countervailing Measures* (MTN.GNG/NG10/W/3, 17 March 1987).
[609] See A. Dunkel, *Trade Policies for a Better Future – The 'Leutwiler Report', the GATT and the Uruguay Round* (Dordrecht: Martinus Nijhoff Publishers, 1987), 174 pp., at 46.

Unsurprisingly, with the launch of the Uruguay Round (1986), the Contracting Parties again picked up the theme of subsidies and CVDs, still defending the same interests: the US continued its 'anti-subsidy crusade',[610] whereas the EC and others, including developing countries, advocated more stringent rules on CVDs.[611] At the same time, Croome underscored that a compromise was facilitated by a growing shared understanding among most countries on the heavy budgetary implications of subsidization and on the risk that any subsidy to gain a competitive advantage would simply be matched by foreign subsidization,[612] leading to 'a self-defeating spiral of subsidization'.[613] Negotiations finally resulted at the end of the Uruguay Round (1994) in the multilateral *SCM Agreement*, which thus binds all WTO Members and is applicable in addition to, but goes 'well beyond merely applying and interpreting',[614] Articles VI, XVI and XXIII of the GATT .

The US hereby successfully advocated for narrowing the three above-mentioned bifurcations. Next to agricultural subsidies, S&D treatment for the more advanced developing countries had to be curtailed, certainly in sectors where they had become internationally competitive.[615] Furthermore, the US called for more effective disciplines on domestic subsidies as practice had shown that they could very well have trade-distorting effects similar to export subsidies (e.g., in the steel sector).[616] In particular, the US proposed to simply prohibit some types of domestic subsidies (operationalized *inter alia* through specified quantitative limits)[617] and, in general, to provide more effective tools to challenge the adverse effects of other domestic subsidies occurring in third country markets as well as in the subsidizing market when no prior tariff concessions have been made.[618] A specific demand of the US was also to discipline more severely the so-called 'targeting' strategy of countries like Japan and some European countries, which it described as 'a government plan or scheme of coordinated

[610] Yet, following the election of Bill Clinton (1992), the negative stance on subsidies altered somewhat (certainly on subsidies for research and development, see below n 1259). See G. Kleinfeld and D. Kaye, 'Red Light, Green Light? The 1994 Agreement on Subsidies and Countervailing Measures, Research and Development Assistance, and US Policy', 28:6 *Journal of World Trade* (1994), 43-63, at 43.

[611] J. H. Barton, J. L. Goldstein, T. E. Josling, and R. H. Steinberg, *The Evolution of the Trade Regime – Politics, Law, and Economics of the GATT and the WTO* (Princeton: Princeton University Press, 2006), 242 pp., at 115-116; Croome, above n 579 , at 60.

[612] Croome, above n 579, at 60.

[613] *Communication from the United States* (MTN.GNG/NG10/W/20, 15 June 1988), at 2.

[614] Appellate Body Report, *Brazil – Desiccated Coconut*, at 181.

[615] If they had become internationally competitive, the US argued, 'the need for subsidies to facilitate the economic development program of that country is not readily apparent'. *Submission by the United States* (MTN.GNG/NG10/W/29, 22 November 1989), at 2; *Communication from the United States* (MTN.GNG/NG10/W/20, 15 June 1988), at 7.

[616] See *Submission by the United States* (MTN.GNG/NG10/W/29, 22 November 1989).

[617] See *Submission by the United States* (MTN.GNG/NG10/W/39, 27 September 1990).

[618] See *Communication from the United States* (MTN.GNG/NG10/W/20, 15 June 1988); *Submission by the United States* (MTN.GNG/NG10/W/40, 5 October 1990).

measures to assist specific export-oriented industries'.[619] Through a combination of subsidization (e.g., R&D subsidies) and market access restrictions, such targeting aimed at obtaining market dominance in technology-intensive sectors (e.g., computer, semi-conductor, aircraft, space) and inflicted a subsidy race among developed countries.[620] Interestingly, the US hereby recognized 'that there are philosophical differences with respect to the appropriate level of government intervention in structuring domestic economic activity and fostering exports', but wanted examination 'whether at a certain point such policies can go beyond the bounds of appropriate government involvement in promoting exports'.[621]

Next to pleading for more stringent multilateral disciplines, the US also unilaterally stepped up the imposition of CVDs and anti-dumping duties in response to foreign 'subsidization' and dumping and the scope of both laws was amended several times to facilitate such imposition during the 1980s.[622] Because Contracting Parties had failed to agree upon a definition of the concept of 'subsidy' in the Subsidies Code[623], all kinds of government interventions (and even private interventions) which (potentially) distort trade could be countervailable, which was in theory the case under US law.[624] Hence, by urging for a narrow subsidy definition and the inclusion of a specificity test, the EC and other countries aimed to curtail the coverage of these CVDs laws.[625] The inclusion of such a subsidy definition in the SCM Agreement was

[619] *Communication from the United States* (MTN.GNG/NG10/W/1, 16 March 1987), at 3; *Communication from the United States* (MTN.GNG/NG10/W/20, 15 June 1988), at 4; *Submission by the United States* (MTN.GNG/NG10/W/29, 22 November 1989), at 1.

[620] See above Part I, Chapter 2, Section 2.1.3. See also, P. Krugman, 'The US Response to Foreign Industrial Targeting', 1984:1 *Brookings Papers on Economic Activity* (1984), 77-131; Hufbauer and Erb, above n 542, at 107-110; A. B. Zampetti, 'The Uruguay Round Agreement on Subsidies – A Forward-Looking Assessment', 29:6 *Journal of World Trade* (1995), 5-29, at 8; T. O. Bayard, K. A. Elliot, *Reciprocity and Retaliation in US Trade Policy* (Washington DC: Institute for International Economics, 1994), 503 pp..

[621] *Communication from the United States* (MTN.GNG/NG10/W/20, 15 June 1988), at 4. See also, *Note by the Secretariat* (MTN.GNG/NG10/20, 3 July 1990).

[622] Baldwin noticed that this rise could be partly explained by the new way anti-dumping and CVDs were administered in the US because this competence was transferred from the Treasury Department to the more protectionist Commerce Department. For the exact numbers of CVD cases over the period of 1954-1994, see Baldwin, above n 534, at 297-327, at 306-309; Hufbauer and Erb, above n 542, at 16-17.

[623] During the Tokyo Round, they considered that any definition would be either under- or over-inclusive and, instead, focused on the effect rather than on the intrinsic nature of subsidies. See Stewart, above n 579, 820. As McGovern observed back in 1986: 'the term "subsidy" is one of the most frequently used and infrequently defined in the whole vocabulary of international trade regulation'. McGovern, above n 596, at 312.

[624] After all, countries could unilaterally define the term 'subsidy' for their CVDs law. The scope in US CVDs law was limited by the 'specificity' requirement. On the evolution of the subsidy definition in US CVDs law, see R. E. Hudec, *Essays on the Nature of International Trade Law* (London: Cameron May, 1999), 396 pp., at 265-267.

[625] Panel Report, *US – Export Restraints*, paras 8.63–8.69.

therefore 'generally considered to represent one of the most important achievements of the Uruguay Round in the area of subsidy disciplines'.[626]

In addition to the SCM Agreement, the sector-specific multilateral *Agreement on Agriculture* was agreed upon in the Uruguay Round after years of demanding negotiations. The Cairns group was formed as a coalition of developed and developing agricultural exporting countries that collectively pushed for further liberalization in this field.[627] Although it subsidized and protected its agricultural market, the US firmly defended the same interests to break the 'vicious circle' of agricultural subsidization mainly because of the severe budgetary implications of its support and the conviction that its agricultural sector would be competitive in an undistorted market.[628] As Croome indicated, the US heavily subsidized its exports but stressed that this was purely to counter subsidization offered by other countries, such as the EC.[629] The US had extensive export credit support and food aid programmes in place under which, according to other countries and observers, exports were indirectly subsidized.[630] On the defending side of the negotiation table were the EC (domestic and export subsidies), Japan and Korea (domestic subsidies), and those developing countries which benefited from preferential access to the EC market or were net-food importing.[631] Targeting primarily EC agricultural export subsidies, the US proposed phasing out all agricultural export subsidies over a period of five years.[632] Most other countries (even the Cairns Group) did not go that far but nonetheless agreed that export subsidies had to be phased out gradually. Hence, the

[626] Panel Report, *US – FSC,* para 7.80. See also T. Collins-Williams and G. Salembier, 'International Disciplines on Subsidies – The GATT, the WTO and the Future Agenda', 30:1 *Journal of World Trade* (1996), 5–17, at 9–10. According to the Leutwiler Report, '(u)nless there can be agreement on definition, talk of 'subsidy' is useless'. See Dunkel, above n 609, at 47-48.
[627] At that time, the group consisted of 14 countries: Argentina, Australia, Brazil, Canada, Chile, Colombia, Fiji, Hungary, Indonesia, Malaysia, New Zealand, the Philippines, Thailand, and Uruguay. Today, the group consists of 19 agricultural exporting countries: Argentina, Australia, Bolivia, Brazil, Canada, Chile, Colombia, Costa Rica, Guatemala, Indonesia, Malaysia, New Zealand, Pakistan, Paraguay, Peru, Philippines, South Africa, Thailand, and Uruguay.
[628] See C. Yeutter, 'US Negotiating Proposal on Agriculture in the Uruguay Round', in E-U Petersmann, and M. Hilf (eds), *The New GATT Round of Multilateral Trade Negotiations* (Deventer: Kluwer Law and Taxation, 1988), 265-270, at 267; Stewart, above n 579, at 142-145 and 172; Croome, above n 579, at 93.
[629] According to the same author, the US was highly competitive in various agricultural markets such as cereals and meat. Croome, above n 579, at 93.
[630] Next to food aid policies, Stewart pointed *inter alia* to the US export credit guarantees scheme, which 'in intent if not in form' is 'similar to the export subsidies offered by the EC and other countries'. Stewart, above n 579, at 145. See also below Part III, Chapter 2, Section 2.2.
[631] Croome, above n 579, at 93.
[632] It is debated whether this ambitious proposal, which even went further than the Cairns group position, genuinely reflected the United States' position or was also inspired by strategic considerations (e.g., to please domestic constituencies or even to undermine the entire negotiations). See Stewart, above n 579, at 172; Croome, above n 579, at 95-96; M. G. Desta, *The Law of International Trade in Agricultural Products – From GATT 1947 to the WTO Agreement on Agriculture* (The Hague: Kluwer Law International, 2002), 488 pp., at 207, footnote 16.

EC was largely isolated in its position in which it only agreed with the reduction of export subsidies but did not suggest any timetable.[633] Targeting in return US practice, the EC and most other countries called to discipline indirect forms of export subsidies (e.g., export credit, food aid). In the end, six types of 'direct' export subsidies were made subject to reduction commitments over an agreed implementation period and other, 'indirect' forms of export subsidies were made subject to an anti-circumvention provision.[634] Next, in line with an initial US proposal, domestic support that had the most distorting impact on trade was aggregated and also made subject to reduction commitments. The details of these subsidy disciplines under the Agreement on Agriculture, and their relationship to the SCM Agreement disciplines, are specified in Chapter 6.[635]

Both the SCM Agreement and Agreement on Agriculture deal with subsidies affecting trade in goods.[636] The Agreement on Agriculture applies to agricultural products and also the SCM Agreement, elaborating the GATT rules on subsidies and CVDs, leaves subsidies affecting trade in services sectors untouched.[637] Indeed, these are exclusively disciplined by the *GATS* but this agreement, which also resulted from the Uruguay Round, seems rather flexible on subsidization. Article XV GATS, dealing explicitly with subsidies, does not impose any substantive obligation upon WTO Members. WTO Members recognize that subsidies may have a distorting effect on trade in services though are only under an obligation to enter negotiations to develop disciplines on subsidies. So far, these negotiations under the Doha Development Round were not very fruitful.[638] In addition, Article XV:2 of the GATS stipulates that if a Member considers that it is adversely affected by a subsidy of another Member it 'may request consultations with that Member' but such request must only be given 'sympathetic consideration'. As illustrated in the case study on export credit support (Part III, Chapter 6), only the non-discrimination principles (i.e., MFN-principle and national treatment principle) might impose substantive obligations on subsidization under GATS. Notice that, contrary to GATT, the obligation of national treatment under the GATS does not explicitly

[633] Stewart, above n 579, at 179. As they did not have substantive export subsidy schemes in place, Japan, Korea, and other countries agreed that agricultural export subsidies had to be gradually phased out. Stewart, above n 579, at 186-190; Croome, above n 579, at 201.
[634] Article 10 of the Agreement on Agriculture.
[635] See below Part II, Chapter 6, Section 6.2.
[636] Marrakesh Agreement Establishing the World Trade Organization, List of Annexes. Both are listed under 'Multilateral Agreements on Trade in Goods' (Annex 1A). See also Panel Report, *US – Softwood Lumber IV*, para 7.28; Panel Report, *US – Upland Cotton*, para 7.1144.
[637] The subsidy itself can, of course, consist of the provision of a service. See Article 1.1(a)1(iii) of the SCM Agreement (see below Part II, Chapter 3, Section 3.1.1.2).
[638] Article XV of the GATS. A look at the *Annual Report of the Working Party on GATS Rules to the Council for Trade in Services (2009)* (S/WPGR/19, 2 October 2009, para 5) reveals that negotiations are not yet in an advanced stage. See R. Adlung, 'Negotiations on Safeguards and Subsidies in Services: A Never-ending Story?', 10:2 *Journal of International Economic Law* (2007), 235-265.

exclude subsidies but is at the same time dependent on specific commitments (Article XVII of the GATS).[639]

1.5. THE DOHA ROUND NEGOTIATIONS

Disciplines under both the SCM Agreement and the Agreement on Agriculture are under revision in the Doha Development Round, which was launched in November 2001 but is still not concluded anno 2010.

First, WTO Members agreed to open the rules set out in the SCM Agreement and Anti-Dumping Agreement for negotiations, with the goal of 'clarifying and improving disciplines' under both agreements, while preserving their 'basic concepts, principles and effectiveness (…) and their instruments and objectives, and taking into account the needs of developing and least-developed participants'.[640] Broadly speaking, the same negotiation positions as under previous rounds seem to be endorsed in implementing this negotiating mandate: the US seems to carry on its anti-subsidy crusade, whereas other WTO Members, in particular developing countries, advocate more policy space for subsidization and more policy constraints upon CVDs.[641] Importantly, this statement also needs to be somewhat nuanced. For instance, the EC endorsed the reinstallation of the green light subsidies but, on the other hand, also proposed to expand the scope of red light subsidies.[642] The US government interventions in response to the financial and economic crisis of 2009/10 (e.g., bailouts in the car industry) might likewise have reduced its appetite to expand the red light category of subsidies along the lines of its own previous proposal. Interestingly, several of the tabled proposals by WTO Members were a direct response to interpretations offered by panels and the Appellate Body and aimed at either codifying or altering their interpretation of SCM Agreement provisions. The latest state of the negotiations is reflected in the draft consolidated text of the Anti-Dumping Agreement and SCM Agreement circulated by the chairman of the Negotiating Group on Rules in December 2008 (*Draft Consolidated Chair Text*).[643] The most important amendments to the existing disciplines proposed in this Draft Consolidated Chair Text will be

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[639] Compare Article III:8(b) of the GATT and Article XVII of the GATS.
[640] *Ministerial Declaration, adopted on 14 November 2001* (WT/MIN(01)/DEC/1, 20 November 2001), para 28.
[641] For an overview of all proposals until 2004, see J. R. Magnus, 'World Trade Subsidy Discipline: Is This the "Retrenchment Round"?', 38:6 *Journal of World Trade* (2004), 985-1047; see also, World Trade Report 2006, above n 574, at 206-207. Magnus concluded at that time that the US position on subsidy disciplines was mixed because it also tabled proposals weakening these disciplines. On balance, the US position seems to be largely in line with their stricter stance towards subsidization adopted in previous rounds.
[642] The EC pushes in particular for stricter disciplines on practices that have the effect of making inputs available to local producers at prices substantially lower than on the international market (see, for example, *Submission of the European Communities, Subsidies* (TN/RL/GEN/135, 24 April 2006).
[643] Negotiating Group on Rules, *New Draft Consolidated Chair Texts of the AD and SCM Agreement* (TN/RL/W/236, 19 December 2008).

integrated in our discussion on the SCM Agreement, though one should keep hereby in mind that this text does not reflect the end of the negotiating process. To paraphrase the words of the chair:

> Not only are there large gaps where on issues of great importance to delegations no solutions are proposed; but few, if any, of the textual proposals that can be found in these new texts can be considered to attract consensus support.[644]

Reflecting upon this draft text at the end of 2009, the Chairman further specified the most controversial and difficult issues in his text:

> (…) there are four major bracketed issues in my draft ASCM text, regarding certain *financing by loss-making institutions*, *export competitiveness*, *export credits* – market benchmarks and export credits – *successor undertakings*. These are important and challenging issues. In addition, the un-bracketed issues related to *regulated pricing* are highly controversial and of comparable importance. And significant issues, such as *pass-through* and *subsidy allocation*, are also addressed through un-bracketed text.[645]

Second, one of the stumbling blocks for closing the Doha Development Round is the disagreement among WTO Members on stricter disciplines under the Agreement on Agriculture. In the Doha Declaration, Members committed with regard to subsidies to negotiate aimed at 'reductions of, with a view to phasing out, all forms of export subsidies' as well as 'substantial reductions in trade-distorting domestic support'.[646] The objective to establish a fair and market-oriented trading system was restated, but non-trade concerns were noted as well. Moreover, S&D treatment of developing countries had to become an integral part of the negotiations. The negotiating positions at the opening of this round were largely in line with those adopted during the Uruguay Round. On the defending side were still situated the industrialized countries such as the European countries (EC, Switzerland, Norway), Japan, and Korea, but also those developing countries which benefited from preferential access to the EC market or were net-food importing. These countries emphasized the multi-functionality of agriculture (i.e., non-trade concerns) to underpin their defensive liberalization stance.[647] 'Demandeurs' of further liberalization were apart from the Cairns group members the US, which indicated its willingness to further cut its support upon the condition of parallel cuts by other countries (e.g., EC) and tariff reductions in both developed as well as developing countries. Finally, a number of developing countries (e.g., India, Turkey, Kenya)[648] shared

[644] Draft Consolidated Chair Text, above n 643, at 1.
[645] Reflecting upon the work undertaken in 2009 on the basis of this draft text, the Chairman conceded that '(t)he process has been long, time-consuming and sometimes tedious'. *Rules Negotiating Group, Statement by the Chairman, Informal Open-Ended Meeting with Senior Officials: 25 November 2009* (TN/RL/W/246, 27 November 2009), at 4 (emphasis added).
[646] *Doha Ministerial Declaration* (WT/MIN(01)/DEC/1, 20 November 2001), para 13.
[647] See above Part I, Chapter 3, Section 3.2.
[648] This was not an organized group. Also included were *inter alia* Pakistan, Zimbabwe, Nicaragua, Kenya, Dominican Republic, Hondouras, El Salvador, Venezuela, Philippines, Indonesia.

the offensive interests of further liberalization in developed countries but adopted a defensive stance regarding domestic liberalization. During the negotiations, several coalitions have been formed (with overlapping and changing membership), whereby countries bundle their negotiating power to advocate shared specific interests. Figure 1 offers an overview of the most active groupings in the agriculture negotiations and amply illustrates the variety of interests among developed as well as developing countries.

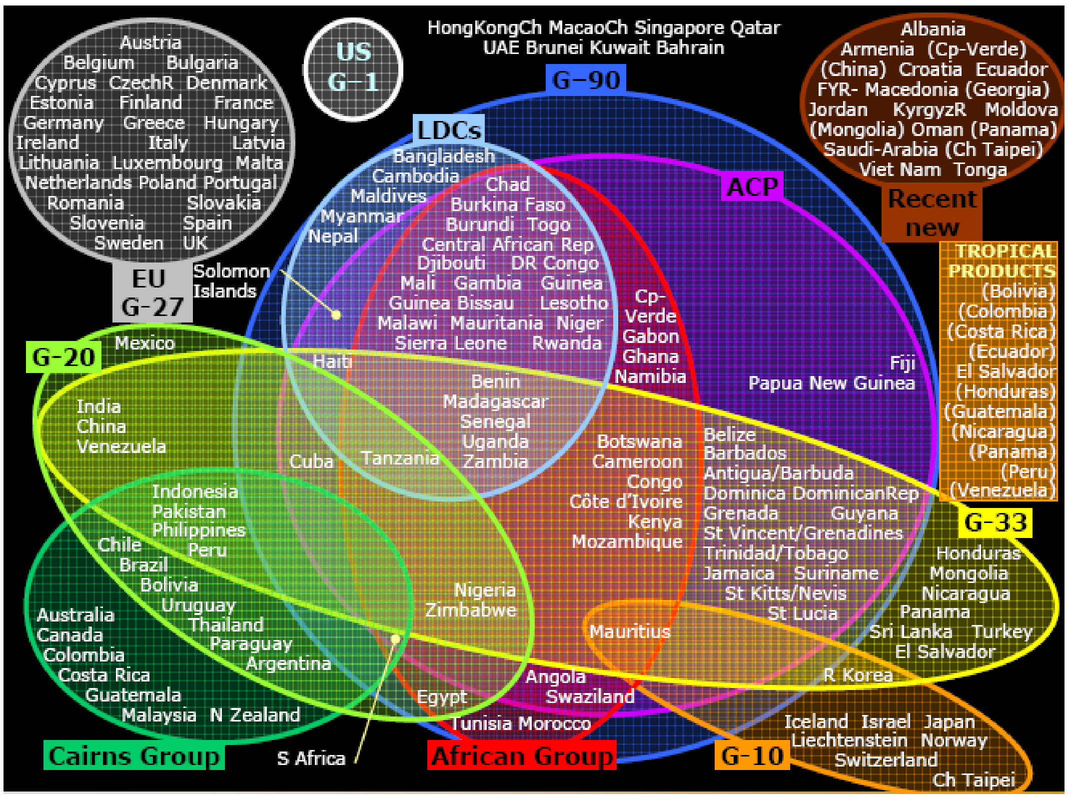

FIGURE 1: COALITIONS IN AGRICULTURE NEGOTIATIONS[649,650]

One of the most important new groupings regarding the agricultural subsidies negotiations is the G-20. In the run-up to the Cancun Ministerial Conference (2003), this alliance of

[649] ACP (African, Caribbean and Pacific countries with preferences in the EU); African group (African members of the WTO); Cairns group (seeking agricultural trade liberalization); G-10 (defensive interests in negotiations by emphasizing non-trade concerns, also known as 'Friends of Multifunctionality'); G-20 (seeking ambitious reforms in developed countries while preserving S&D treatment); G-33 (seeking flexibility for developing countries to undertake limited market opening in agriculture; also known as 'Friends of Special Products'); G-90 (African Group + ACP + LDCs); LDCs (least-developed countries); Recent new members (RAMs) (seeking lesser commitments because of their accession commitments); Tropical products (seeking greater market access for tropical products). A specific group missing in the figure is the Cotton-4, also called 'C-4' (a West African coalition of cotton producing countries (Benin, Burkina Faso, Chad, and Mali) seeking cuts in cotton subsidies and tariffs).

[650] WTO website, available at: http://www.wto.org/english/tratop_e/agric_e/negoti_groups_e.htm.

developing countries was formed and brought together countries belonging to the Cairns group as well as other developing countries that push for more liberalization in developed countries, while aiming at preserving substantive S&D treatment for their own agricultural policies.[651] The emergence of the G-20 is a good illustration of the general more active and shared position claimed by larger developing countries in the negotiations. Arguably, this presents the single most important difference with the negotiating setting in the Uruguay Round. In analyzing the relevant current disciplines on agricultural subsidies, the modifications inscribed in the latest *Revised Draft Modalities for Agriculture* (December 2008) will be scrutinized.[652] Needless to say, these texts certainly do not reflect a consensus among these different coalitions, though they give a good impression of the state and future directions of the negotiations. To paraphrase the words of this chair:

> Everything is conditional in the deepest sense in any case. But the changes made at this time now represent a best estimate of where there is additional good reason to believe there would prove to be consensus if everything was to come together as a modalities package.[653]

If the Doha Round would be put back on track, the Draft Consolidated Chair Text and Revised Draft Modalities for Agriculture dating from the end of 2008 would likely form the point of departure in the negotiations on new disciplines for industrial and agricultural subsidies.

[651] This alliance was a direct response to the *EC – US Joint Text*. To break the deadlock of the negotiations in the run-up to the Cancun Ministerial Conference (2003), Members agreed that the US and EC had to take the lead to bridge their disagreement and propose a joint draft for further negotiations. This resulted in the *EC – US Joint Text* (August 2003), which was, however, not well received by the other Member as it reflected too much their own interests.

[652] See Revised Draft Modalities for Agriculture (TN/AG/W/4/Rev.4, 6 December 2008).

[653] Revised Draft Modalities for Agriculture, above n 652, at 1.

2. OBJECT AND PURPOSE OF THE SCM AGREEMENT

The SCM Agreement does not contain a preamble,[654] which might indicate the wide divergence in views on subsidies among the drafters.[655] The object and purpose of the agreement has been clarified in the case law.[656] In the view of the Panel in *Brazil – Aircraft*, the SCM Agreement aims to 'impose multilateral disciplines on subsidies which distort international trade'.[657] In the light of the negotiating history outlined above, this description might just tell half the story. Indeed, the Appellate Body in *US – Carbon Steel* more broadly described its main object and purpose as 'to increase and improve GATT disciplines relating to the use of *both* subsidies *and* countervailing measures'.[658] In *US – Softwood Lumber IV*, the Appellate Body finally confirmed, in an even more nuanced way, that the SCM Agreement aims indeed to strengthen the GATT disciplines on the use of both subsidies and CVDs, 'while, recognizing at the same time, the right of Members to impose such measures under certain conditions'.[659,660]

[654] The Anti-Dumping Agreement also does not provide a preamble. In contrast, a preamble was included in the Subsidies Code.

[655] Another explanation might be that the drafters did not consider a preamble necessary. The drafts of the SCM Agreement (Dunkel Text and Cartland Drafts) did not contain a draft preamble either.

[656] In absence of any explicit statement on its object and purpose, the Panel in *Canada – Aircraft*, considered it 'unwise to attach undue importance to arguments concerning the object and purpose of the SCM Agreement'. Panel Report, *Canada – Aircraft*, para 9.119. Yet, such implicit downplaying of the relevance of the object and purpose in the interpretative process as stipulated in the Vienna Convention is not reflected in other relevant case law.

[657] Panel Report, *Brazil – Aircraft*, para 7.26; see also Panel Report, *US – Export Restraints*, paras 8.60–8.62.

[658] Appellate Body Report, *US – Carbon Steel*, para 73.

[659] Appellate Body Report, *US – Softwood Lumber IV*, paras 64, 95. The Appellate Body referred to its decision in *US – Carbon Steel*.

[660] Citing this statement, the Appellate Body in *US – Countervailing Duty Investigation on DRAMS* also referred to the SCM Agreement as reflecting a 'delicate balance between the Members that sought to impose more disciplines on the use of subsidies and those that sought to impose more disciplines on the application of countervailing measures'. Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 115.

3. SCOPE OF THE SCM AGREEMENT

Pursuant to the SCM Agreement, a subsidy shall be deemed to exist if two distinctive elements are present: (i) a financial contribution by a government[661] or any form of income or price support in the sense of Article XVI of the GATT[662] (ii) that confers a benefit.[663] Moreover, to be subject to the disciplines of the SCM Agreement, the subsidy must be specific.[664]

3.1. FINANCIAL CONTRIBUTION BY A GOVERNMENT OR INCOME OR PRICE SUPPORT

3.1.1. Financial contribution

Article 1.1(a)(1) of the SCM Agreement points to three different kinds of financial contributions:[665]

> (i) a government practice involves a direct transfer of funds (e.g., grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g., loan guarantees);
> (ii) government revenue that is otherwise due is foregone or not collected (e.g., fiscal incentives such as tax credits);[666]
> (iii)a government provides goods or services other than general infrastructure, or purchases goods.

The Panel in *US – Export Restraints* correctly decided that this list is exhaustive and this reading was implicitly confirmed by the Appellate Body in *US – Softwood Lumber IV*.[667] As a result, the Panel decided that export restraints are not captured, even though they could very well benefit domestic producers similarly as when a financial contribution is offered.[668]

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661 Article 1.1(a)(1) of the SCM Agreement.
662 Article 1.1(a)(2) of the SCM Agreement.
663 Article 1.1(b) of the SCM Agreement.
664 Article 1.2 of the SCM Agreement.
665 Article 1.1(a)(1)(iv) of the SCM Agreement is not considered as a type of financial contribution because it deals with the way, namely indirectly, that the government provides one of the different forms of financial contributions [(i) through (iii)] (see below Part II, Chapter 3, Section 3.1.2.2). This approach is consistent with the case law. See, for example, Panel Report, *US – Export Restraints*, para 8.73; Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.53; Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, paras 124-125.
666 For the exception provided by footnote 1 of the SCM Agreement, see below Part II, Chapter 3, Section 3.1.1.3.
667 Panel Report, *US – Export Restraints*, para 8.69. Referring to this Panel report, the Appellate Body observed 'that not all government measures capable of conferring benefits would necessarily fall within Article 1.1(a). If that were the case, there would be no need for Article 1.1(a), because all government measures conferring benefits, *per se*, would be subsidies'. Appellate Body Report, *US – Softwood Lumber IV*, para 52, footnote 35; see also Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 114.
668 See, however, below for the discussion on the scope of 'income or price support' (Part II, Chapter 3, Section 3.1.3). Panel Report, *US – Export Restraints*, para 8.75. In its reasoning, the Panel stressed that the requirement of 'financial contribution' was precisely advocated by most countries to counter the purely effect-based definition of the US (paras 8.63–8.72). The US proposed during the Uruguay Round that the term '(actionable) subsidy' was defined as 'any government action or combination of actions which confers a benefit on the recipient firm(s)'. See *Elements of the Framework for*

Although some authors regret such a closed list in the light of the ingenuity of governments to invent new forms of assistance, the interpretation is legally solid.[669] Moreover, our discussion will illustrate that these three types of financial contributions are formulated, and interpreted, broadly to cover a wide variety of financial contributions.

3.1.1.1. The (potential) direct transfer of funds and liabilities

The first type of financial contribution (Article 1.1(a)(1)(i) of the SCM Agreement) refers to a government practice involving (potential) direct transfers of funds and liabilities. The Appellate Body in *Japan – DRAMs (Korea)* concluded that the term 'funds' not only refers to 'money' but that it encompasses financial resources and other financial claims more generally.[670] Transactions similar to those explicitly listed (i.e., grants, loans, and equity infusion) are thus also covered. For instance, debt forgiveness, the extension of a loan maturity, and an interest rate reduction are all considered direct transfers of funds because they improve the financial position of the borrower.[671] Likewise, a debt-to-equity swap intended to address a company's deteriorating financial condition is deemed a direct transfer of funds to the company.[672] This broad reading implies that the change in ownership (by an equity infusion or debt-to-equity swap) itself can constitute a financial contribution and that it is perfectly possible for an owner to make a financial contribution to itself (e.g., cash grant by a government to a government-owned company).[673] Export credit guarantees or insurance are examples of *potential* direct transfer of funds because funds are only transferred in case the export credit is not repaid due to a covered risk.[674] Obviously, a financial contribution exists regardless whether these funds have to be paid in the end and thus whether the *potential* transfer effectively materializes.[675]

Negotiations – Submission by the United States (MTN.GNG/NG10/W/29, November 22, 1989), section II.1(a). See also Appellate Body Report, *US – Softwood Lumber IV*, para 52, footnote 35.

[669] In the view of Rubini, the provision presents contradictory indications on the exhaustive, or merely illustrative, nature of the list. However, the notion 'i.e.' in Article 1.1(a)(1) of the SCM Agreement, meaning 'id est (Latin), that is' (Oxford English Dictionary) indicates that this list is closed. Moreover, the Cartland I draft referred to 'such as', instead of 'i.e.', which suggests that the latter is not included by coincidence. L. Rubini, 'The International Context of EC State Aid Law and Policy: The Regulation of Subsidies in the WTO', in A. Bondi, P. Eeckhout, and J. Flynn (eds), *The Law of State Aid in the European Union* (Oxford: Oxford University Press, 2004), 149-188, at 160.

[670] Appellate Body Report, *Japan – DRAMs (Korea)*, para 250.

[671] Appellate Body Report, *Japan – DRAMs (Korea)*, para 251; Panel Report, *Korea – Commercial Vessels*, para 7.413.

[672] Appellate Body Report, *Japan – DRAMs (Korea)*, para 252; Panel Report, *Korea – Commercial Vessels*, paras 7.411-7.413

[673] Panel Report, *Korea – Commercial Vessels*, paras 7.419-7.423.

[674] Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.87. See also below Part III.

[675] Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.87.

Such (potential) direct transfer of funds and liabilities made by governments or public bodies are covered, according to the Panel in *Korea – Commercial Vessels*, 'irrespective of whether or not they involve the exercise of regulatory powers or taxation authority'.[676] The Panel indeed concluded that the phrase 'governance practice' in Article 1.1(a)(1)(i) of the SCM Agreement simply denotes the author of the action (i.e., government). Hence, this phrase does not restrict the scope of this financial contribution to functions *normally* performed by governments.[677] The phrase 'government practice' is thus redundant to interpret this first type of financial contribution.

3.1.1.2. The provision of goods or services or purchase of goods other than general infrastructure

The second form of financial contribution (Article 1.1(a)(1)(iii) of the SCM Agreement) refers to the provision of goods or services by the government. The Appellate Body in *US – Softwood Lumber IV* endorsed an expansive definition of the terms 'goods' and 'provision'. First, *goods* include 'property and possessions', and thus also immovable property.[678] Second, goods or services are *provided* by the government not only when they are directly supplied or given but also when an intangible right is offered having the effect of making these goods/services available.[679] What matters is that the transaction makes the goods/services available.[680] This only supposes 'a reasonably proximate relationship between the action of the government providing the good or service on the one hand, and the use or enjoyment of the good or service by the recipient on the other'.[681] Accordingly, the Appellate Body in *US – Softwood Lumber IV* agreed with the Panel that the Canadian provincial governments 'provided' 'goods' by granting 'the right to harvest' 'standing timber'.[682] The fact that these goods are natural resources is irrelevant because an exception is only made for 'general infrastructure'.[683]

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676 Panel Report, *Korea – Commercial Vessels*, para 7.29.
677 Panel Report, *Korea – Commercial Vessels*, paras 7.28-7.31.
678 The Appellate Body thereby even expanded the definition of the Panel, which understood the term 'goods' in its broad ordinary meaning as 'tangible or movable personal property, other than money'. It is not required according to the Appellate Body that such goods are tradable. See Appellate Body Report, *US – Softwood Lumber IV*, paras 58–67; Panel Report, *US – Softwood Lumber IV*, paras 7.23–7.30.
679 Appellate Body Report, *US – Softwood Lumber IV*, paras 68-75.
680 'Rights over felled trees or logs crystallize as a natural and inevitable consequence of the harvesters' exercise of their harvesting rights'. Appellate Body Report, *US – Softwood Lumber IV*, para 75.
681 Hence, 'a government must have some control over the *availability* of a specific thing being "made available"'. It therefore does not capture general government acts such as any property law in a jurisdiction. Appellate Body Report, *US – Softwood Lumber IV*, paras 70-71.
682 Appellate Body Report, *US – Softwood Lumber IV*, para 76.
683 Panel Report, *US – Softwood Lumber IV*, para 7.25. See also G. Gagné and F. Roch, 'The US – Canada Softwood Lumber Dispute and the WTO Definition of Subsidy', 7:3 *World Trade Review* (2008), 547-572, at 555.

Indeed, governmental provision of 'general infrastructure' is explicitly excluded from the subsidy definition (Article 1.1(a)(1)(iii) of the SCM Agreement).[684] The scope of this exception is, however, not yet clarified in the case law. The Appellate Body has only underscored that, by its terms, only 'infrastructure of a *general* nature' and thus not all kinds of infrastructure is excluded.[685] The ordinary meaning as well as the negotiating history suggest that 'infrastructure' includes *inter alia* transport infrastructure (e.g., roads, railways, or ports) but also power supplies.[686] The pivotal issue is, of course, how generally available such infrastructure should be to be covered under this exception. The negotiating history indicates that this exception was often discussed together with the 'specificity' element (Article 2 of the SCM Agreement) and green light subsidies.[687] Some scholars have therefore argued that Article 2 of the SCM Agreement could provide useful context for interpreting the term 'general infrastructure'.[688]

Next to *providing* goods/services, the government makes a financial contribution under Article 1.1(a)(1)(iii) of the SCM Agreement when it *purchases* goods. To be precise, the *purchase* of services is not covered because this might affect trade in services rather than trade in goods. Hence, only the GATS disciplines would be relevant to discipline such purchases of services.

3.1.1.3. The government foregoes revenue which is otherwise due

The previous discussion has illustrated that a government could subsidize by *positive* action when it makes financial (Article 1.1(a)(1)(i) of the SCM Agreement) or in-kind (Article 1.1(a)(1)(iii) of the SCM Agreement) transfers. This final type of financial contribution confirms that a government could likewise subsidize by *negative* action when it refrains from collecting revenue which is otherwise due. Internal taxes, covering direct (raised on income)

[684] Appellate Body Report, *US – Softwood Lumber IV*, para 72.
[685] Appellate Body Report, *US – Softwood Lumber IV*, para 60.
[686] The Oxford Dictionary Online describes infrastructure as 'the basic physical and organizational structures (e.g., buildings, roads, power supplies) needed for the operation of a society or enterprise'. Examples of 'infrastructure' are mostly not listed in communications of negotiating Members, except for Korea, which referred to 'harbour facilities, electric power, or transportation systems' as examples of social infrastructure. *Communication from the Republic of Korea* (MTN.GNG/NG10/W/34, 18 January 1990).
[687] See, for example, *Communication from the Republic of Korea* (MTN.GNG/NG10/W/34, 18 January 1990). See also, World Trade Report 2006, above n 574, at xxxviii.
[688] See K. Adamantopoulos, 'Article 1 SCMA', in R. Wolfrum, P-T. Stoll, and M. Koebele (eds), *WTO: Trade Remedies* (Heidelberg: Max Planck Institute for Comparative Public Law and International Law, 2008), 423-452, at 439. The US also referred to 'basic infrastructure where there are no de iure or de facto limitations on use', which resembles the elements for determining specificity under Article 2 (see below Part II, Chapter 3, Section 3.3). See *Submission by the United States* (MTN.GNG/NG10/W/29, 22 November 1989).

as well as indirect (raised on products) taxes,[689] and import duties (tariffs) present two general sources of government revenue. WTO case law has dealt, in a rather expansive way, with cases concerning revenue alleged to be foregone under both sources.

Before analyzing this case law, it should be highlighted that the SCM Agreement explicitly excludes from the subsidy definition, and thus from the scope of the SCM Agreement, rebates of indirect taxes and import duties upon exportation.[690] The remission or exemption for exports of indirect taxes and import duties are therefore not considered as revenue foregone. The Appellate Body in *US – FSC* confirmed that rebates on *direct* taxes are not covered by this exception.[691] We will return to this exception regarding indirect taxes and import duties when discussing remission and drawback systems under the Illustrative List of Export Subsidies.[692]

Under what conditions would other forms of internal tax and tariff measures qualify as revenue foregone? Regarding internal taxes, WTO-adjudicating bodies provided some important insight in the *US – FSC* case.[693] In this politically sensitive case, the EC challenged the US income tax exemption for FSCs under the SCM Agreement. The US direct tax system is a worldwide tax system because it generally taxes income of US citizens and residents earned anywhere in the world. Nonetheless, foreign-source income of FSCs was exempted from worldwide taxation ('FSC exemption').[694] Consequently, the EC argued, and the Panel as well as the Appellate Body agreed, that the US was foregoing revenue by virtue of the FSC exemption. The Appellate Body clarified that 'foregoing' suggests that the government has given up an entitlement to raise revenue that it would otherwise have raised. This cannot

[689] For a definition of 'direct tax' and 'indirect tax,' see footnote 58 of the SCM Agreement.
[690] Footnote 1 of the SCM Agreement. See also Ad Article XVI of the GATT, Article VI:4 of the GATT, and Annex I, items (g), (h), and (i) of the SCM Agreement (see below).
[691] Because footnote 1 refers to 'the exemption of an exported *product* from duties or taxes *borne by the like product*' (emphasis added). See Appellate Body Report, *US – FSC*, para 93. The same argument holds for Ad Article XVI of the GATT (and Article VI:4 of the GATT). The exclusion of direct taxes is also confirmed by the different treatment of indirect and direct taxes under Annex I SCM Agreement [compare items (g) and (e)]. See on the exclusion of direct taxes in the GATT provisions, Jackson, above n 544, at 300–303.
[692] See below Part II, Chapter 4, Section 4.1.1.2.2.
[693] For comments on these cases, see C. Carmichael, 'Foreign Sales Corporation – Subsidies, Sanctions, and Trade Wars', 35 *Vanderbilt Journal of Transnational Law* (2002), 151–210; R. Howse and D. J. Neven, 'United States – Tax treatment for 'Foreign Sales Corporations' Recourse to Arbitration by the United States under Article 22.6 of the DSU and Article 4.11 of the SCM Agreement (WT/DS108/ARB)', 4:1 *World Trade Review* (2005), 101–124; R. E. Hudec, 'Industrial Subsidies: Tax Treatment of 'Foreign Sales Corporations', in E-U. Petersmann and M. A. Pollack (eds), *Transatlantic Economic Disputes – the EU, the US, and the WTO* (Oxford: Oxford University Press, 2003), 175–205.
[694] The FSCs are foreign corporations responsible for the sale or lease of goods produced in the US for export. If these FSCs are foreign subsidiaries of US corporations, they received greater benefits under the FSC laws.

refer to an 'entitlement in the abstract, because governments, in theory, could tax *all* revenues'.[695] Instead, it implies 'some defined, normative benchmark against which a comparison can be made'.[696] As to the basis of this comparison, the Appellate Body concluded that it must be the 'tax rules applied by the member in question'.[697] As to the substance of this comparison, the Appellate Body (in *US – FSC* and *US – FSC (Article 21.5 – EC)*) seems to have developed a two-prong test.[698] When the measure at issue can be described as an 'exception' to a 'general rule', the 'but for' test can be applied.[699] Here, the benchmark is the situation that would exist but for the measure at issue. Applied to the *US – FSC* case, the Panel examined whether foreign income of FSCs would be taxed higher if the FSCs scheme did not exist.[700] However, the Appellate Body realized that the 'but for' test is not watertight.[701] After all, 'it is usually very difficult to isolate a "general rule" of taxation and "exceptions" to that "general" rule' given the variety and complexity of domestic tax systems.[702] Moreover, the Appellate Body realized that 'it would not be difficult to circumvent such a test by designing a tax regime under which there would be *no* general rule that applied formally to the revenues in question, absent the contested measure'.[703] Therefore, in most cases, panels should use the fiscal treatment of 'legitimately comparable income' as benchmark.[704] The Appellate Body applied this test to the ETI Act,[705] by which the US aimed to bring its tax system in conformity with the *US – FSC* ruling.[706] It compared the way the US

[695] Appellate Body Report, *US – FSC*, para 90 (emphasis in the original).
[696] Appellate Body Report, *US – FSC*, para 90.
[697] Otherwise, the WTO would 'somehow compel Members to choose a particular kind of tax system'. Appellate Body Report, *US – FSC*, para 90.
[698] Appellate Body Report, *US – FSC (Article 21.5 – EC)*, para 91.
[699] Appellate Body Report, *US – FSC (Article 21.5 – EC)*, para 91.
[700] Panel Report, *US – FSC*, para 7.45.
[701] Some authors read the report of the Appellate Body in *US – FSC (Article 21.5 – EC)* as rejecting the 'but for' test in all cases. Although some elements in paragraph 91 might underpin this reading (e.g., the last sentence), the general thrust of paragraph 91 seems to indicate that the Appellate Body is not outlawing the 'but for' test in those cases where it is still possible to apply it. The wording 'not (…) always *requires*' (emphasis by the Appellate Body itself) indicates that panels are still allowed to apply it whenever possible. The 'but for' test is applicable when but for the measure at issue, the income falls under the general tax rule. The general tax rule applies by definition to legitimately comparable income. So, the outcome of both tests would be the same. As an indication, the Panel, applying the 'but for' test and the Appellate Body, applying the 'legitimately comparable income' test, reached the same conclusion in *US – FSC (Article 21.5 – EC)*.
[702] Appellate Body Report, *US – FSC (Article 21.5 – EC)*, para 91.
[703] Appellate Body Report, *US – FSC (Article 21.5 – EC)*, para 91 (emphasis in the original).
[704] Appellate Body Report, *US – FSC (Article 21.5 – EC)*, para 91. As an illustration, the Appellate Body explains that 'if the measure at issue is concerned with the taxation of foreign-source income in the hands of a domestic corporation, it might not be appropriate to compare the measure with the fiscal treatment of such income in the hands of a foreign corporation'. Appellate Body Report, *US – FSC (Article 21.5 – EC)*, para 92.
[705] 'ETI' stands for the 'FSC Repeal and Extraterritorial Income Exclusion Act of 2000'.
[706] This was contested again by the EC (Panel Report, *US – FSC (Article 21.5 – EC)*; Appellate Body Report, *US – FSC (Article 21.5 – EC)*). Both the Panel and Appellate Body concluded that the US had not implemented the Dispute Settlement Body's recommendations and rulings. In response, the US

taxed income under the ETI Act with the way it taxed 'other' foreign-source income and found a 'marked contrast' between them.[707] So, without much ado, the Appellate Body considered other foreign-source income as legitimately comparable income.[708] It observed that 'absent the ETI measure, the US *would* tax the income under the "otherwise" applicable rules of taxation'.[709] Apparently, the 'but for' test seems to examine how the income at issue *is* taxed but for the tax measure at issue from a *legal* viewpoint, whereas the 'legitimately comparable income' test seems to find out how the income *would* be taxed but for the measure at issue from a *policy* viewpoint.[710] In essence, the 'legitimately comparable income' test would thus close the loopholes left open by the 'but for' test. Yet, the determination by panels of 'legitimately comparable income' is even more difficult and intrusive than the application of the 'but for' test.

The second source of government revenue discussed in the case law consists of import duties (tariffs). It seems obvious that the imposition of tariffs *as such* cannot constitute a subsidy. Yet, as the Panel explained in *US – Export Restraints*, a solely effect-based approach toward subsidies would encompass tariffs. Indeed, import duties are, *par excellence*, government measures that distort trade. So, in the Panel's view, the financial contribution requirement precisely blocks the effect-based approach and thus avoids that tariffs as such fall under the ambit of the SCM Agreement.[711] The imposition of tariffs is not considered as a subsidy to

enacted the 'American Jobs Creation Act of 2004'. Yet, the Panel and Appellate Body determined that the US still did not meet its obligations (Panel Report, *US – FSC (Article 21.5 – EC II)*; Appellate Body Report, *US – FSC (Article 21.5 – EC II)*).

707 Appellate Body Report, *US – FSC (Article 21.5 – EC)*, paras 98–105.

708 What if legitimately comparable income is subject to different tax rules? The Appellate Body addressed this complex question but did not solve it *in abstracto*:

> 'We recognize that a Member may have several rules for taxing comparable income in different ways. For instance, one portion of a domestic corporation's foreign-source income may not be subject to tax in any circumstances; another portion of such income may always be subject to tax; while a third portion may be subject to tax in some circumstances. In such a situation, the outcome of the dispute would depend on which aspect of the rules of taxation was challenged and on a detailed examination of the relationship between the different rules of taxation. The examination under Article 1.1(a)(1)(ii) of the SCM Agreement must be sufficiently flexible to adjust to the complexities of a Member's domestic rules of taxation'.

Appellate Body Report, *US – FSC (Article 21.5 – EC)*, para 91, footnote 66.

709 Appellate Body Report, *US – FSC (Article 21.5 – EC)*, para 103 (emphasis added).

710 If the 'but for' test is applicable, both tests would reach the same conclusion (see above n 701).

711 In the words of the Panel:

> 'It is, however, doubtful that the concept of financial contribution contained in Article 1.1(a) of the SCM Agreement seeks to bring such government action within the ambit of the SCM Agreement. To the contrary, by introducing the notion of financial contribution, the drafters foreclosed the possibility of the treatment of *any* government action that resulted in a benefit as a subsidy. (…) To hold that the concept of financial contribution is about the effects, rather than the nature, of a government action would be effectively to write it out of the Agreement, leaving the concepts of benefit and specificity as the sole determinants of the scope of the Agreement'.

Panel Report, *US – Export Restraints*, para 8.38 (emphasis in the original).

the import-competing industry.[712] However, the government does provide a financial contribution to the importer when it foregoes revenue by providing tariff exemptions (similar to when it provides tax exemptions).[713] In *Indonesia – Autos*, the parties agreed that the import duty (and the sales tax) exemptions represented revenue foregone by Indonesia.[714] The Appellate Body reached the same conclusion in *Canada – Autos*, applying the 'but for' test[715] as developed in the *US – FSC* case: 'through the import duty exemption, Canada has ignored the "defined, normative benchmark" that it established for itself for import duties on motor vehicles under its normal MFN rate and, in so doing, has foregone "government revenue that is otherwise due" '.[716]

Before concluding upon these three categories of financial contributions, it seems appropriate to take one step back and reconsider the scope of Article III:8(b) of the GATT. This provision exempts the payment of subsidies exclusively to domestic producers from the national treatment discipline.[717] Are all three types of financial contribution covered by this exemption? The answer seems to be negative because, as the Appellate Body in *Canada – Periodicals* held, this exemption covers 'only the payment of subsidies which involves the *expenditure* of revenue by a government'.[718] Clearly, when the government refrains from collecting revenue it would otherwise raise (type 3 of a financial contribution; Article 1.1(a)1(ii) of the SCM Agreement), the government does not spend any revenue.[719] Indeed,

[712] As the Panel recognized, deciding otherwise would raise a question of consistency with Article II of GATT 1994, dealing with Members' schedules of concessions. If a Member applies a bound tariff rate (thus consistent with its schedule of commitment), another Member would still be allowed to argue that this constitutes an actionable subsidy if it causes adverse effects. Panel Report, *US – Export Restraints*, paras 8.36–8.38.

[713] Recall that footnote 1 of the SCM Agreement provides an exception.

[714] Panel Report, *Indonesia – Autos*, para 14.155.

[715] 'We note, once more, that Canada has established a normal MFN duty rate for imports of motor vehicles of 6.1 per cent. Absent the import duty exemption, this duty would be paid on imports of motor vehicles'. Appellate Body Report, *Canada – Autos*, para 91.

[716] Appellate Body Report, *Canada – Autos*, para 91. As a defense, Canada invoked the exemption provided by footnote 1 of the SCM Agreement. Yet, the Appellate Body dismissed this argument because footnote 1 deals with duty or tax exemptions for exported goods, whereas the measure at issue applied to imports of motor vehicles sold for consumption in Canada (Appellate Body Report, *Canada – Autos*, para 92).

[717] Article III:8(b) of the GATT elaborates that this includes 'payments to domestic producers derived from the proceeds of internal taxes or charges applied consistently with the provisions of this Article and subsidies effected through governmental purchases of domestic goods'.

[718] Appellate Body Report, *Canada – Periodicals*, at 34 (emphasis added).

[719] Also other types of financial contributions seem to fall outside the scope of Article III:8 of the GATT. In *Canada – Periodicals*, Canada applied reduced postal rates to Canadian publications. The provision of postal services can be considered as a financial contribution in the sense of 1.1(a)1(iii) SCM Agreement. The Appellate Body stated that it did 'not see a reason to distinguish a reduction of tax rates on a product from a reduction in transportation or postal rates' and concluded that the reduced postal rates were not justified by Article III:8(b) of the GATT. Consequently, the Appellate Body reversed the Panel's finding that the Canadian postal rate scheme was compatible with Article III:8(b) of the GATT. Appellate Body, *Canada – Periodicals,* at 34–35.

the GATT Panel in *US – Malt Beverages*, on which the Appellate Body in *Canada – Periodicals* relied, held that the reduction of taxes on a good does not qualify as a payment of a subsidy under Article III:8(b). Hence, it is not exempted from the national treatment discipline.[720] In conclusion, this case law indicates that measures whereby the government refrains from collecting taxes otherwise due can be scrutinized under the GATT national treatment provision.[721] Such a financial contribution is, if it confers a benefit and is specific, also disciplined by the SCM Agreement. Additionally, as elaborated below, local content subsidies, which are subsidies contingent on the use of domestic over imported goods, also fall outside the scope of the exception of Article III:8(b) of the GATT.[722]

3.1.2. By a government

3.1.2.1. Direct financial contribution: By a government or public body

The financial contribution should be made by 'a government or any public body within the territory of a Member' (Article 1.1(a)(1) of the SCM Agreement). This provision covers, first of all, financial contributions by national, regional, as well as local governments. This conforms to the public international law principle that the conduct of any organ of the State, at whatever layer, is attributable to that State.[723]

In addition, a financial contribution could be made by a public body. Yet, this concept is not further defined in the SCM Agreement. According to the Panel in *Korea – Commercial Vessels*, a public body is one that is 'controlled by the government' and government ownership of 100 per cent is considered 'highly relevant and often determinative of government control'.[724] To reach the conclusion of *government control* over the Export-Import Bank of Korea (KEXIM), the Panel thus found primary evidence in 100 per cent government ownership. But the Panel also took other factors into account, such as the role of

[720] GATT Panel Report, *US – Malt Beverages*, paras 5.7–5.12; Appellate Body, *Canada – Periodicals,* at 34.

[721] This covers at least indirect taxation, which is captured by Article III:2 of the GATT (see, for example, GATT Panel Report, *US – Malt Beverages*). Direct taxes (on income), in contrast, are considered as outside the scope of Article III:2 of the GATT. See, for example, M. Matsushita, T. J. Schoenbaum, and P. Mavroidis, *The World Trade Organization – Law, Practice and Policy*, 2nd ed (Oxford: Oxford University Press, 2006), 889 pp., at 246; R. Bhala, *Modern GATT Law – A Treatise on the General Agreement on Tariffs and Trade* (London: Sweet & Maxwell, 2005), 1269 pp., at 108–110. Nonetheless, the Panel in *US – FSC (Article 21.5 – EC)* concluded that measures related to direct taxation can be captured by Article III:4 of the GATT: 'Article III:4 applies to measures conditioning access to income tax advantages in respect of certain products' (para 8.144). After all, as the Panel observed, 'nothing in the plain language of the provision (*Article III:4*) specifically excludes requirements conditioning access to income tax measures from the scope of application of Article III (…)' (emphasis added). Panel Report, *US – FSC (Article 21.5 – EC)*, para 8.142. See also M. Daly, 'WTO Rules on Direct Taxation', 29:5 *The World Economy* (May 2006), 527-557.

[722] See GATT Panel Report, *Italy – Agricultural Machinery*.

[723] Article 4 of the Draft Articles on State Responsibility.

[724] Panel Report, *Korea – Commercial Vessels*, paras 7.50-7.56 and 7.352–7.356.

the government in appointing key functions, its extensive control over the parameters within which KEXIM had to operate, and its description as an 'export credit agency', suggesting an hierarchical relationship of a principal (i.e., government) and an agent (i.e., KEXIM).[725] Likewise, the Korea Asset Management Corporation (KAMCO) was considered a public body because it was 100 per cent government owned and government-appointed officials held important positions.[726]

The Panel in *Korea – Commercial Vessels* thus opted for the control criterion as a sufficient condition applicable to single out whether a 'public body' is present and 100 per cent ownership seems largely sufficient to meet this control criterion. On the other hand, the same Panel considered that 'a public policy objective' or 'creation through public statute' might also be indicative of the public nature of an entity.[727] But both elements are neither sufficient nor necessary to determine the existence of a public body since the control criterion is sufficient on its own to tackle this question.[728] Importantly, the Panel thus dismissed that a government controlled entity needs to pursue a public policy objective to label it as a 'public body'. In case an entity is effectively controlled by the government (or other public bodies), it qualifies as a public body and 'any action by that entity is attributable to the government'.[729]

As Mavroidis et al have pointed to, WTO Members such as the US and EC seemed to have been somewhat surprised by this wide interpretation of 'public body'. Indeed, they had treated 100 per cent government-owned entities as *private* instead of public bodies in their respective CVDs procedures on Korean imports of DRAMs (see next section). This qualification implied that the presence of an indirect financial contribution had to be demonstrated. They had to show that these 'private' entities were 'entrusted or directed' by the Korean government to make a financial contribution.[730] Indeed, the Panel in *US – Countervailing Duty Investigation on DRAMS* observed that 'depending on the circumstances, 100 per cent government ownership might well have justified the treatment of such creditors

[725] Panel Report, *Korea – Commercial Vessels*, paras 7.50-7.56.
[726] Panel Report, *Korea – Commercial Vessels*, paras 7.352–7.356.
[727] Clarifying that both criteria are not sufficient conditions on their own to determine the existence of a public body, the Panel gave as examples: '(…) the fact that a private philanthropist may pursue public policy objectives should probably not cause that person to be treated as a "public body". In addition, the privatization of a company might be finalized through a public statute'. Panel Report, *Korea – Commercial Vessels*, para 7.55.
[728] Korea's argument that an entity does not constitute a 'public body' if it engages in market (non-official) activities on commercial terms failed, according to the Panel, to distinguish between the 'financial contribution by a government' element and 'benefit' element of the subsidy definition. The Panel considered it simply irrelevant whether transactions are made on commercial terms to determine whether an entity is a 'public body'. Panel Report, *Korea – Commercial Vessels*, paras 7.44-7.49.
[729] Panel Report, *Korea – Commercial Vessels*, paras 7.50-7.51. See also P. C. Mavroidis, P. A. Messerlin, and J. M. Wauters, *The Law and Economics of Contingent Protection in the WTO* (Cheltenham: Edward Elgar, 2008), 606 pp., at 316.
[730] Mavroidis, Messerlin, and Wauters, above n 729, at 317-318.

as public bodies'.[731] Yet, because the US Department of Commerce (USDOC) had considered these as private bodies, the additional demonstration of entrustment or direction had to be fulfilled. Likewise, the Panel in *EC – Countervailing Measures on DRAM Chips* remarked that it did 'not wish to imply that it would not be possible or justified to treat a 100 per cent government owned entity as a public body, depending on the circumstances'.[732] Again, the Panel examined the entrustment/direction issue regarding a 100 per cent government-owned Korean bank that had been qualified by the EC as a private bank. In this examination, the Panel in *EC – Countervailing Measures on DRAM Chips* stressed that the extent of government-ownership could also be 'a very relevant factor' in assessing entrustment or direction.[733] Yet, government control is not sufficient on itself because it should be demonstrated, '(i)n the case of a 100 per cent government-owned bank (…) that the government *actually exercised* its shareholder power to direct the bank' to offer subsidized financing.[734] The EC was successful in demonstrating such direction, whereas the US failed to meet the burden of 'entrustment or direction'.[735] In sum, when confronted with 100 per cent government owned entities, CVDs authorities are well advised to simply qualify these entities as public bodies in first order. The same advice holds in case the government is not the only shareholder but holds the large majority of shares.[736] In second order, CVDs authorities could still seek to demonstrate that these entities were 'entrusted or directed' by the government, whereby the degree of government ownership would again be a relevant factor.

[731] Although the Panel explicitly stated that 'we do not make any findings that 100 per cent government-owned entities will necessarily constitute public bodies'. Panel Report, *US – Countervailing Duty Investigation on DRAMS*, paras 6.11, 7.8, footnote 29, para 7.62, footnote 80.
[732] Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.119, footnote 129. On the other hand, the EC had considered that the Korea Development Bank (KDB) was a public body because it was not only 100 per cent government-owned, but 'also entrusted with a specific public policy role which obliged it to carry out policies normally followed by the government'. The EC thus seemed to consider a public policy objective as a necessary element of a 'public body'. See Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.90.
[733] After all, '(i)t is clear that, as the sole shareholder, it is easier for the government to direct the bank to act in a certain manner than in a situation of no or only minor government involvement'. Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.119.
[734] Panel Report, *EC – Countervailing Measures on DRAM Chips*, paras 7.119-1.120; see also, Panel Report, *US – Countervailing Duty Investigation on DRAMS*, para 7.62.
[735] Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.125; Panel Report, *US – Countervailing Duty Investigation on DRAMS*, para 7.63.
[736] In footnote 129 (see above n 732 and full text), the Panel in *EC – Countervailing Measures on DRAM Chips* continued that a 'similar consideration applies to our discussion and analysis of Chohung Bank and the KEB in which the government of Korea held 80 per cent and 43 per cent of the shares, respectively, at the time of the investigation'. See also Panel Report, *EC – Countervailing Measures on DRAM Chips*, paras 7.127, footnote 136, 7.134, footnote 142.

3.1.2.2. Indirect financial contribution: Entrustment or direction of a private body

In addition to *direct* financial contributions by the government or a public body, Article 1.1(a)(1)(iv) of the SCM Agreement shows that such contributions can be made *indirectly* by a government. This occurs when the government (or any public body within its territory[737]) makes payments to a funding mechanism or when it entrusts or directs a private body to carry out one of the three types of financial contribution.[738] This provision is 'in essence, an anti-circumvention provision':[739] it prevents governments from circumventing the SCM Agreement by channeling their contribution through an intermediary or by using a private body as a 'proxy'[740] to make that contribution.[741] Hence, it assumes 'a demonstrable link between the government and the conduct of the private body'.[742] What is the required strength of this link and how should it be demonstrated? Insights on both questions could be revealed from the three cases in which Korea challenged CVDs imposed by respectively the US, the EC, and Japan. These three WTO Members had imposed CVDs on the imports of DRAMs (i.e., dynamic-random access memories) from Korea.[743] A common question that that had to be solved in all three cases was indeed whether it was demonstrated that private

[737] Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.49.
[738] Strictly speaking, five different elements can be distinguished in Article 1.1(a)(1)(iv) of the SCM Agreement: (1) a government 'entrusts or directs'; (2) 'a private body'; (3) 'to carry out one or more of the type of functions illustrated in' subparagraphs (i)–(iii) of Article 1.1(a)(1); (4) 'which would normally be vested in the government'; and (5) 'the practice, in no real sense, differs from practices normally followed by governments'. See Panel Report, *US – Export Restraints*, para 8.25. Reviewing the meaning of elements (4) and (5) in light of the negotiating history, panels have understood a function 'normally vested in the government' broadly as any function which 'involves the levy of taxation or the expenditure of revenue' (e.g., loans, restructuring measures). Panel Report, *US – Countervailing Duty Investigation on DRAMS*, para 737; Panel Report, *Korea – Commercial Vessels*, para 7.30. This broad description implies that the scope of this provision seems not narrowed by elements (4) and (5) as all cases of government entrustment or direction of a private body to carry out one of the functions illustrated under (i)-(iii) (elements (1) to (3)) *ipso facto* seem to involve the levy of taxation or the expenditure of revenue. Adamantopoulos also viewed these elements 'of a clarificatory nature rather than qualifying or conditional'. Adamantopoulos, above n 688, at 444. See also Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 108.
[739] Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 113; Appellate Body Report, *US – Softwood Lumber IV*, para 52.
[740] Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, paras 108, 115, 116.
[741] See Appellate Body Report, *US – Softwood Lumber IV*, para 52.
[742] Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 112. Interestingly, the Appellate Body referred to the Commentaries to the ILC Draft Articles (Article 8, footnote 8, Commentary (6), pp. 107-108) to conclude that 'the conduct of private bodies is presumptively not attributable to the State'. Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 112, footnote 179.
[743] See *US – Countervailing Duty Investigation on DRAMS*; *EC – Countervailing Measures on DRAM Chips*; *Japan – DRAMs (Korea)*. For a discussion of Japan's first CVDs determination, see Y. J. Cho, 'Japan's First CVDs Determination: With Particular Emphasis on the Issue of Direction and Entrustment', 43:2 *Journal of World Trade* (2009), 417-437.

creditors were 'entrusted or directed' by the Korean government to bailout one of its DRAMs producers (i.e., Hynix Semiconductor).[744]

First, regarding the required strength of this link, the Appellate Body in *US – Countervailing Duty Investigation on DRAMS* explained that 'entrustment' does not only cover acts of delegation but occurs more broadly where a government gives responsibility to a private body. Similarly, 'direction' is not limited to acts of command but covers all situations where the government exercises its authority over a private body.[745] The Appellate Body thus endorsed a broad interpretation of both standards but, at the same time, also emphasized that '(i)n most cases, one would expect entrustment or direction of a private body to involve some form of threat or inducement'.[746] Certainly, 'mere policy pronouncements by a government would not, by themselves' be sufficient and the required nexus implies 'a more active role than mere acts of encouragement'.[747] Further, entrustment or direction 'cannot be inadvertent or a mere by-product of governmental regulation'.[748] Lastly and importantly, the Appellate Body agreed with the Panel in *US – Export Restraints* that entrustment and direction do not cover 'the situation in which the government intervenes in the market in some way, which may or may not have a particular result simply based on the given factual circumstances and the exercise of free choice by the actors in that market'.[749] It always has to be demonstrated that private bodies were effectively entrusted or directed by the government to make a financial contribution in the meaning of Article 1 of the SCM Agreement.

Second, regarding the demonstration of such link between the government and private bodies, this 'will hinge on the particular facts of the case'.[750] No specific standard for demonstrating entrustment or direction is in place. The Appellate Body has correctly specified that such demonstration is, strictly speaking, not a pure fact but 'a *legal* assessment based on a proven

[744] Recall that, in some instances, panels have indicated that they would consider some of these private creditors rather as public bodies (see above n 733, 734).

[745] Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 116. Indeed, panels had limited the terms 'entrusts' and 'directs' to, respectively, acts of 'delegation' and 'command'. See Panel Report, *US – Export Restraints*, paras 8.28–8.29; Panel Report, *Korea – Commercial Vessels*, para 7.368; Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.52.

[746] Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 116.

[747] Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 114.

[748] Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 114.

[749] Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 114; Panel Report, *US – Export Restraints*, para 8.31. The Panel in *US – Export Restraints* had therefore rejected the US argument that an export restriction should be labeled as an entrustment or direction by the government on private upstream producers to provide goods domestically because the US saw no functional difference between a restriction on exporting a product and an instruction to sell that product domestically. Panel Report, *US – Export Restraints*, paras 8.26-8.44.

[750] Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, paras 116, 138.

set of facts'.[751] Acknowledging that such entrustment or direction 'will rarely be formal, or explicit' (i.e., lack of so-called 'smoking gun'), the Panel in *Japan – DRAMs (Korea)* agreed that it is 'likely to be based on pieces of circumstantial evidence'.[752] In this respect, the Appellate Body in *US – Countervailing Duty Investigation on DRAMS* had underscored that 'individual pieces of circumstantial evidence are unlikely to establish entrustment or direction'.[753] All such pieces should be put together to determine whether, on the basis of the *totality* of evidence, 'entrustment or direction' might be reasonably inferred.[754]

A first indication of government entrustment or direction is present if the private actor acts against its commercial interests.[755] As explained above, a second relevant factor in the view of several panels is the degree of government ownership of the private body.[756] To be sure, both elements are not sufficient on their own because they do not reveal anything about the government's actual conduct.[757] Nonetheless, the Panel in *EC – Countervailing Measures on DRAM Chips* had concluded that a combination of both elements (i.e., large government shareholder status and commercial unreasonableness) could, in the absence of strong evidence to the contrary, suffice to infer government direction.[758] Moreover, both elements are not strictly needed to reach the conclusion of government entrustment/direction. For instance, entrustment or direction by the government could be present 'even where the financial contribution is made on commercially reasonable terms'.[759]

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[751] Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 150, footnote 277 (emphasis in the original).

[752] Panel Report, *Japan – DRAMs (Korea)*, para 7.73. The Panel in *EC – Countervailing Measures on DRAM Chips* (para 7.57) had also stressed that entrustment or direction could be 'explicit or implicit, informal or formal'.

[753] The Appellate Body acknowledged that in cases of entrustment or direction, 'the evidence that is publicly-available, (…) , will likely be of a circumstantial nature'. Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 150, footnote 277, para 154.

[754] After all, 'the significance of individual pieces of evidence may become clear only when viewed together with other evidence'. Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 154. For a discussion, see J. F. Francois and D. Palmeter, 'US – Countervailing Duty Investigation on DRAMs', 7:1 *World Trade Review* (2008), 219-229, at 222-225.

[755] Appellate Body Report, *Japan – DRAMs (Korea)*, para 138; Panel in *Japan – DRAMs (Korea)*, para 7.70; Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.59.

[756] Panel Report, *EC – Countervailing Measures on DRAM Chips*, paras 7.119-7.120; see also, Panel Report, *US – Countervailing Duty Investigation on DRAMS*, para 7.62.

[757] Commercial unreasonableness could, according to the Panel in *Japan – DRAMs (Korea)* (para 7.70), not be determinative of itself because it says nothing about the conduct of the government itself, and thus needs to be coupled with other evidence. See also, Appellate Body Report, *Japan – DRAMs (Korea)*, para 138; Panel Report, *EC – Countervailing Measures on DRAM Chips*, paras 7.59, 7.119-7.120, 7.127.

[758] Panel Report, *EC – Countervailing Measures on DRAM Chips*, paras 7.131, 7.134. The Panel in *Japan – DRAMs (Korea)* seemed to endorse this conclusion (para 7.253, footnote 462), though, in my view, even the combination of both elements reveals nothing about the government's effective conduct, which was the reason why the same panels rejected that government ownership and commercial unreasonableness on their own were sufficient (see above n 757).

[759] Of course, such transaction might fail to pass the benefit threshold (see below Part II, Chapter 3, Section 3.2). Appellate Body Report, *Japan – DRAMs (Korea)*, para 138. Obviously, a government

Next to these two factors, other findings for demonstrating 'entrustment or direction' have also been considered relevant. These elements include the government's revealed intent or motivation (e.g., the Korean government's intent to save Hynix, through direct intervention if needed)[760], its coercive behaviour in related transactions[761], or, when demonstrated in a CVDs investigation, the failure of interested parties to cooperate with the investigating authority.[762] All such pieces of evidence should be put together so as to determine whether the legal assessment of 'entrustment or direction' could be reasonably inferred.[763]

In conclusion, as advocated by the US and Australia during the Uruguay Round, the SCM Agreement covers so-called 'private subsidies', wherein the financial contribution is made by a private body but at the direction or entrustment of the government. Hence, a subsidy does not necessarily involve a financial contribution by the government itself. What is more, this illustrates that a subsidy within the meaning of Article 1 of the SCM Agreement not necessarily involves a cost upon the government itself.[764] Nevertheless, purely 'private subsidies', without any form of governmental involvement, are not targeted.[765] In the words of the Appellate Body, 'situations involving exclusively private conduct – that is, conduct that is not in some way attributable to a government or public body –' fall outside the scope of Article 1.1(a)(1) of the SCM Agreement.[766]

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does not need to be a shareholder but the quality of evidence for demonstrating direction/entrustment is set higher in case the government holds no shareholder power. See Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.140.

[760] This is revealed 'on the basis of statements properly attributed to named government agencies or representatives, in the absence of express denials, corrections, or other evidence to the contrary'. Panel Report, *Japan – DRAMs (Korea)*, para 7.104; Appellate Body Report, *Japan – DRAMs (Korea)*, para 133. In *US – Countervailing Duty Investigation on DRAMS*, the Panel had also found that the Korean government had a policy to save Hynix. Panel Report, *US – Countervailing Duty Investigation on DRAMS*; Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, paras 155, 186.

[761] Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 156.

[762] Again, non-cooperation is insufficient on its own to show entrustment or direction. Combined with commercial unreasonableness, complete failure to cooperate by Citibank sufficed to show direction by the Korean government. Panel Report, *EC – Countervailing Measures on DRAM Chips*, paras 7.60-7.61, 7.139-7.145. Other factors, such as the fact that the restructuring took place in the framework of a formal government act, have also been considered. See, for example, Panel Report, *EC – Countervailing Measures on DRAM Chips*, para7.125; Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 186.

[763] This means that when a panel is requested to review a CVDs-investigating authority's determination of 'entrustment or direction' based on several of such different individual pieces of circumstantial evidence, it should, according to the Appellate Body, 'consider that evidence in its totality, rather than individually, in order to assess its probative value with respect to the agency's determination'. Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 150. See below Part II, Chapter 5, Section 5.2.5.

[764] Appellate Body, *Canada – Aircraft*, para 160; Panel Report, *Canada – Aircraft*, para 9.115.

[765] Such private subsidies were countervailable under US law. See Stewart, above n 579, at 898–899.

[766] Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 107; see also Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.50. To be precise, it might be covered under the notion of 'income or price support' (Article 1.1(a)(2)).

3.1.3. Income or price support

A subsidy in the meaning of the SCM Agreement can exist, not only when the government directly or indirectly provides a financial contribution but also when there is 'any form of income or price support in the sense of Article XVI GATT 1994' (Article 1.1(a)(2) of the SCM Agreement). [767] Yet, the notions of income and price support are not defined by either the GATT or the SCM Agreement. Given that these provisions do not clearly demarcate the scope of this second alternative, one would hope to find some further guidance in the case law. Unfortunately, no panel or Appellate Body Report has interpreted this second alternative so far. What is more, panels and the Appellate Body sometimes seem to overlook it when they define the term 'subsidy' under the SCM Agreement.[768] Most Members – and maybe also those panel and Appellate Body reports that neglect this second alternative – might hold the view that 'income or price support' is only relevant to the field of agriculture.[769] But the reference to income and price support in Article 1.1(a)(2) of the SCM Agreement *juncto* Article XVI of the GATT is not explicitly limited to the field of agriculture.[770]

The inclusion of this second alternative in the definition of 'subsidy' was, as Luengo clarifies, a way to include Article XVI of the GATT into the SCM Agreement. Yet, no one reflected upon the consequences of this inclusion.[771] Whereas most authors tend to pay little attention to this second alternative,[772] Luengo argues that it is vital for defining subsidies because it substantially broadens the scope of subsidies beyond financial contributions by a government to include any form of income or price support that causes trade distortion.[773] Consequently, the notion of 'any form of income support' would capture government measures that directly or indirectly have an impact on the income of the recipient, without involving a financial

[767] The Appellate Body in *US – FSC* noted that Article 1.1(a)(2) of the SCM Agreement is a reference to Article XVI:1 of the GATT and not to Article XVI:4 of the GATT. See Appellate Body Report, *US – FSC*, para 117, footnote 135.

[768] See, for example, Panel Report, *US – Export Restraints*, para 8.69; Appellate Body Report, *Canada – Aircraft*, para 156; Appellate Body Report, *US – Countervailing Measures on Certain EC Products*, para 139. In contrast, the Appellate Body in *US – Softwood Lumber IV* correctly noticed that that the range of government measures capable of providing subsidies (i.e., Article 1.1(a)(i)-(iv) SCM Agreement) 'is broadened still further by the concept of 'income or price support' in paragraph 2 of Article 1.1(a)'. Appellate Body Report, *US – Softwood Lumber IV*, para 52.

[769] It was invoked in two cases concerning agricultural subsidies. See Appellate Body Report, *EC – Export Subsidies on Sugar*, paras 92 and 98; Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, para 5.147.

[770] As indicated, Article XVI:1 of the GATT refers to 'subsidies, including any form of income or price support'. Moreover, in the view of Jackson, the definition of 'subsidy' in Article XVI:4 (on export subsidies for non-primary products) encompasses government price-support schemes (e.g., government purchases and sales with net infusion of government funds), even though the phrase 'including income or price support' is not included in Article XVI:4. See Jackson, above n 544, at 397.

[771] G. Luengo, *Regulation of Subsidies and State Aids in WTO and EC Law* (The Netherlands: Kluwer Law International, 2006), 586 pp., at 122.

[772] Notice also that the World Trade Report 2006 was rather cryptic on this issue. World Trade Report 2006, above n 574, at 197.

[773] Luengo, above n 771, at 120–123.

contribution. For example, Luengo holds that an export restraint on a certain product can be considered a subsidy in the sense of the SCM Agreement given that it provides an indirect income support to the domestic purchasers of the product in question because they can buy the product at a reduced price.[774] So, it should have been possible for the Panel in *US – Export Restraints*, which only considered and dismissed the first alternative ('financial contribution'), to conclude that export restraints were a form of income support in the sense of Article 1.1(a)(2) of the SCM Agreement.[775]

Nonetheless, such a broad interpretation seems to render the first alternative meaningless. At first sight, all financial contributions might have a (direct or indirect) impact on the income of the recipient. As the Panel in *US – Export Restraints* stressed, the requirement of 'financial contribution' into the definition of subsidy was precisely advocated by most countries to counter the purely effect-based definition by the US.[776] An expansive interpretation of 'income or price support in the sense of Article XVI GATT' as advocated by Luengo would bring the definition of 'subsidy' close to such an effect-based approach, covering almost any government action that confers a benefit and causes trade distortion.[777]

3.2. BENEFIT

To be labeled a subsidy under the SCM Agreement, the financial contribution by the government (or income/price support) should 'confer a benefit' (Article 1.1(b) of the SCM Agreement). In *Canada – Aircraft*, the Appellate Body has set out the essential elements on how this second layer of the subsidy definition should be understood. Two fundamental aspects of this determination were discerned.

First, the Appellate Body started from the observation that such a benefit 'could not exist in the abstract, but must be received and enjoyed by a beneficiary or a recipient'.[778] This recipient could be a 'person, natural or legal, or a group of persons'.[779] Whereas the financial contribution element focuses on the government, in the determination of a 'benefit' the focus shifts toward the recipient of the contribution.[780] The benefit element should thus be clearly

[774] Luengo, above n 771, at 120.
[775] Luengo, above n 771, at 120, footnote 60.
[776] Panel Report, *US – Export Restraints*, paras 8.63–8.72.
[777] Paraphrasing the Panel in *US – Export Restraints*, 'the door would be reopened to the countervailing of *benefits* regardless of the nature of the government action that gave rise to them' and this 'would effectively render the "financial contribution" requirement meaningless'. Panel Report, *US – Export Restraints*, para 8.74. Recall also the wording of the Appellate Body in *US – Softwood Lumber IV* as cited above n 667.
[778] Appellate Body Report, *Canada –Aircraft* , para 154.
[779] Appellate Body Report, *Canada – Aircraft*, para 154.
[780] Appellate Body Report, *Canada – Aircraft*, para 156.

distinguished from the 'financial contribution' component, although, as illustrated below, this might *de facto* not always be relevant.

Second, to determine whether such a recipient has received a benefit by virtue of the financial contribution (or income/price support), the Appellate Body observed that 'this implies some kind of comparison' because:

> (…) there can be no 'benefit' to the recipient unless the 'financial contribution' makes the recipient 'better off' than it would otherwise have been, absent that contribution. In our view, the marketplace provides an appropriate basis for comparison in determining whether a 'benefit' has been 'conferred', because the trade-distorting potential of a 'financial contribution' can be identified by determining whether the recipient has received a 'financial contribution' on terms more favorable than those available to the recipient in the market.[781]

Hence, the Appellate Body developed what could be labeled the *private market test*.[782] A benefit arises if 'the recipient has received a "financial contribution" on terms more favourable than those available to the recipient in the market'.[783] Thus, if private actors would have provided the financial contribution at the same conditions, the government's action would not confer a benefit upon the recipient. As illuminated in the Appellate Body's statement, this private market test exactly fits the rationale behind the 'benefit' element. This rationale has been adequately formulated by the Panel in *Korea – Commercial Vessels*: it 'acts as a screen to filter out commercial conduct'.[784] If the government acts similarly as a commercial player, its action does not distort trade.

In developing both parts of its reasoning, the Appellate Body found contextual guidance in Article 14 of the SCM Agreement. This provision sets guidelines for the calculation by the CVDs-investigating authority of the amount 'of a subsidy in terms of the benefit *to the recipient*'.[785] A benefit is conferred by each of the listed examples of financial contributions (i.e., equity investments, loans, loan guarantees, the provision of goods or services or purchase of goods) when made on more favourable than market terms. Article 14 of the SCM Agreement is therefore considered 'highly relevant context'[786] at the disposal of the WTO-adjudicating bodies or CVDs-investigating authorities to decide on whether these listed examples confer a benefit under Article 1.1(b) of the SCM Agreement. Notice that these listed examples in Article 14 of the SCM Agreement cover the two types of financial

[781] Appellate Body Report, *Canada – Aircraft*, para 157.
[782] It is sometimes labeled as the private investor test. Given that not all types of financial contributions are made by 'investors', the broader term 'private market test' seems more appropriate.
[783] Appellate Body Report, *Canada – Aircraft*, para 158. The Appellate Body hereby agreed with the Panel. See Panel Report, *Canada – Aircraft*, paras 9.111-9.120.
[784] Panel Report, *Korea – Commercial Vessels*, para 7.28.
[785] Article 14 of the SCM Agreement (emphasis added). The Panel and Appellate Body considered this relevant context in particular because it explicitly refers to the benefit 'conferred pursuant to paragraph 1 of Article 1'. Appellate Body Report, *Canada – Aircraft*, paras 155, 158; Panel Report, *Canada – Aircraft*, para 9.112. See also Appellate Body Report, *US – Lead and Bismuth II*, para 57.
[786] Panel Report, *EC – Countervailing Measures on DRAM Chips,* para 7.173.

contributions for which a substantive benefit analysis will have to be undertaken: (potential) direct transfer of funds[787] and the provision of goods/services or purchase of goods.[788] Indeed, the benchmark for determining whether a financial contribution is given in the form of 'revenue foregone' equally detects whether a benefit is conferred. Although the benefit threshold should formally still be passed for this third type of financial contribution, a separate substantive analysis will not be required because a benefit upon the recipient is *ipso facto* generated in all cases whereby revenue is foregone by the government.[789]

By turning the benefit analysis to the recipient and focusing on the marketplace as point of comparison, the Appellate Body in *Canada – Aircraft* sided with the Panel that the benefit analysis is not concerned with the notion of a cost-to-government.[790,791] Read together with the financial contribution element, this implies that a subsidy does not necessarily involve a cost upon the government.[792] Indeed, even if a financial contribution involves no cost upon the government, a subsidy exists when it makes the recipient better off. For example, the government can borrow funding on the private market and pass this through to a private actor at an interest rate that is not available to the latter when he would borrow directly on the private market. Without any cost to the government,[793] a subsidy is provided because the financial contribution (Article 1.1(a)(1)(i)) made by the government confers a benefit upon the recipient.[794] Hence, the requirement of a cost-to-government as a necessary element of a subsidy is rejected. This had been fruitlessly proposed by the EC and some other countries

[787] See Article 1.1.(a)(1)(i) *juncto* Article 14(a),(b),(c) of the SCM Agreement. Those examples of financial contributions explicitly mentioned under Article 1.1(c)(1)(i) are also listed under Article 14 of the SCM Agreement: (a) equity capital, (b) loan, (c) loan guarantees. The items listed in Article 14 could also be used by analogy for those types of financial contributions that are not explicitly mentioned under Article 1.1(c)(1)(i) (e.g., debt-to-equity swap). Obviously, in case a grant (Article 1.1.(a)(1)(i) of the SCM Agreement) is provided by the government, a benefit is *ipso facto* conferred. Hence, this item is not listed under Article 14 of the SCM Agreement. See also, Panel Report, *Mexico – Olive Oil*, para 1.158.

[788] See Article 1.1(a)(1)(iii) *juncto* Article 14(d) of the SCM Agreement.

[789] Likewise, the concept of 'income, or prices support' also seems to imply a benefit.

[790] Appellate Body Report, *Canada – Aircraft*, paras 154–156; Panel Report, *Canada – Aircraft*, paras 9.111-9.120; Panel Report, *Korea – Commercial Vessels*, para 7.84.

[791] Notice that those provisions in the SCM Agreement referring to a cost-to-government standard, such as some items of the Illustrative List on Export Subsidies (Illustrative List) as well as Annex IV, are not considered relevant context with regard to the benefit analysis. The Illustrative List is not relevant because it determines whether a *prohibited export subsidy* exists and not whether *a subsidy* exists within the meaning of Article 1 of the SCM Agreement (Panel Report, *Canada – Aircraft*, para 9.117). Regarding Annex IV of the SCM Agreement, the Appellate Body concluded that this 'has nothing to do with whether a "*benefit*" has been conferred, nor with whether a measure constitutes a subsidy within the meaning of Article 1.1' (Appellate Body Report, *Canada – Aircraft*, para 159; Panel Report, *Canada – Aircraft*, paras 9.113, 9.116).

[792] Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.191; Panel Report, *Canada – Aircraft*, para 9.117.

[793] To be precise, the governments still incur an opportunity cost.

[794] Contextual support could be found in Article 14(b) of the SCM Agreement.

when drafting the SCM Agreement.[795] Instead, as endorsed by the US during the Uruguay Round, the benefit-to-recipient forms the relevant benchmark under the subsidy definition of Article 1 of the SCM Agreement.[796] It will be illustrated in the case study on export credit support (Part III) that this interpretation ensures that all WTO Members are treated equally regarding the subsidy definition in Article 1 of the SCM Agreement. At the same time, it raises the interesting question on how this definition relates to the cost-to-government standard elaborated under some items of the Illustrative List on Export Subsidies.

In sum, shifting the focal point to the recipient and taking the marketplace as benchmark has been the consistent response of panels and the Appellate Body to decide on the benefit element. Yet, they have been confronted with complex interpretative questions on both aspects, which will be analyzed in the next sections.

3.2.1. Determination of the relevant benchmark

3.2.1.1. The adequacy of remuneration in case the government provides goods or services

As the Panel in *Japan – DRAMs (Korea)* accurately summarized, it is 'now well established' that the benefit-concept is 'defined by reference to the market, such that a financial contribution confers a benefit when it is made available on terms that are more favourable than the recipient could have obtained on the market'.[797] Private market prices that are effectively available to the recipient should be used as relevant point of reference: would the recipient operating in its particular market be worse off absent the government contribution? When the government provides goods or services, the adequacy of remuneration should therefore be determined in relation to the market conditions in the country of provision (Article 14(d) of the SCM Agreement). But could such private market prices prevailing in the domestic market still be used as benchmark in case these prices are distorted by the very same financial contribution made by the government?

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795 See *Note by the Secretariat, Meeting of 6 November 1990* (MTN.GNG/NG10/24, 29 November 1990).
796 See *Submission by the United States* (MTN.GNG/NG10/W/39, 27 September 1990). This holds insofar the benefit-to-recipient is, of course, the result of a financial contribution by the government or income, or price support.
797 Panel Report, *Japan – DRAMs (Korea)*, para 7.275.

This thorny query was central in the *US – Softwood Lumber* dispute.[798,799] In its CVDs investigation, USDOC had relied on *US* private stumpage fees as relevant benchmark for deciding on whether *Canadian* public stumpage fees conferred a benefit to Canadian lumber producers. Because the Canadian government 'so dominates the *Canadian market* for timber that the below-market government prices suppress prices in the small private market for timber in Canada', USDOC considered that the only reasonable alternative was to make 'use of other prices commercially available to Canadian lumber producers on the world market'.[800] Canada, on the other hand, argued that the question whether a benefit is conferred 'depends on whether the Canadian producers were better off than other purchasers who buy the same good from other sellers *in the country subject to the investigation*'.[801] After all, it highlighted that this benchmark was prescribed under Article 14(d) of the SCM Agreement. This establishes that the provision of goods by a government shall not be considered as conferring a benefit unless it is made for less than adequate remuneration and this:

> (…) shall be determined in relation to prevailing *market conditions for the good* or service *in question in the country of provision* or purchase (including price, quality, availability, marketability, transportation and other conditions of purchase or sale).[802]

Significantly, both the Panel in *US – Softwood Lumber IV* and the Appellate Body endorsed the US reasoning from an economic point of view. In situations where government involvement is so substantial that private prices may be artificially suppressed because of the prices charged for the same goods by the government, the Panel reasoned that:

> A comparison of the conditions of the government financial contribution with the conditions prevailing in the private market would not fully capture the extent of the distortion arising from the government financial contribution, a result that in our view would not necessarily be the most sensible one from the perspective of economic logic.[803]

The use of private market prices as a benchmark in those circumstances could, as the US highlighted, lead to 'a circular comparison of a government price with, in effect, itself'.[804] Indeed, one could not but agree that the private market test assumes that the price setting by

798 See, in particular, *US – Softwood Lumber III* (US preliminary CVDs determination challenged by Canada) and *US – Softwood Lumber IV* (US final CVDs determination challenged by Canada). For an elaborated case note of the *Softwood – Lumber* dispute, see Gagné and Roch, above n 683.
799 This discussion concentrated on the calculation of the benefit (Article 14(d) of the SCM Agreement) but is, of course, highly relevant to the question of whether a benefit exists in the first place (Article 1.1(b) of the SCM Agreement). For the close link between both provisions, see Appellate Body Report, *US – Softwood Lumber IV*, paras 84–85.
800 According to the US, the Canadian government timber sales accounted for more than 80 per cent of the total market. Panel Report, *US – Softwood Lumber III*, para 7.36 (emphasis added).
801 Panel Report, *US – Softwood Lumber III*, para 7.31 (emphasis in the original).
802 Emphasis added.
803 Panel Report, *US – Softwood Lumber IV*, para 7.58.
804 Panel Report, *US – Softwood Lumber IV*, para 7.58; Appellate Body Report, *US – Softwood Lumber IV*, para 93.

private actors is not determined by the very same financial contribution. What is more, it might even be suggested that, to some extent, the private market test fails to detect exactly those domestic subsidies that have the most trade-distorting potential. After all, this test is not suitable in cases where the government's involvement is so dominant that it effectively determines the domestic market prices or that it even prevents the emergence of a private market for the same good. Notice already that this argument referring to the government's predominant role in the economy exactly explains why there was a tradition to not impose CVDs against so-called 'non-market economies'.[805]

Even though it shared the economic logic behind the US approach, the Panel rejected this approach from a legal perspective. Article 14(d) of the SCM Agreement left in its interpretation no other option than to use in-country market prices, unless in the exceptional cases in which the government is the *sole* domestic provider or administratively controls all of the prices.[806] Because none of these exceptional cases was present *in casu* and it could not 'substitute its economic judgment for that of the drafters', the Panel sided with Canada that USDOC should have used Canadian private lumber prices as benchmark.[807] The Appellate Body, however, endorsed a broader reading of Article 14(d) of the SCM Agreement that could respect the economic logic. Hence, it concurred with the US basic point that 'prices in the market of the country of provision are the primary, but not the exclusive, benchmark for calculating benefit'. [808] The Appellate Body further clarified, at least to some extent, when ánd how such an alternative benchmark could be used. Both elements are discussed in turn.

The Appellate Body considered that other than in-country market prices could be used in situations 'where the government has such a predominant role in the market, as a provider of certain goods, that private suppliers will align their prices with those of the government-provided goods; in other words, a situation where the government effectively acts as a "price-setter" and private suppliers are "price-takers"'.[809] To be clear, this concerns situations whereby private suppliers become *de facto* price takers as a result of the government's predominant role in that very same market. Moreover, the Appellate Body emphasized that the required degree of dominance is not present simply because the government is a

[805] See below Part II, Chapter 3, Section 3.2.1.2.
[806] After all, in those cases there would simply not be another in-country price than the government price if it is assumed that there are no imports. This implies that there would not be 'a market' in the sense of Article 14(d) of the SCM Agreement. Panel Report, *US – Softwood Lumber IV*, paras 7.57, 7.60.
[807] See Panel Report, *US – Softwood Lumber IV*, paras 7.59–7.60; Panel Report, *US – Softwood Lumber III*, paras 7.39–7.59. For a comment, see M. Benitah, 'Softwood Lumber: Exact Significance of the Recent Canadian Victory before the WTO and Prospects in the Context the Pending Second Lumber Case', 3:2 *The Estey Centre Journal of International Law and Trade Policy* (2002), 346–356.
[808] Appellate Body Report, *US – Softwood Lumber IV*, paras 82-97.
[809] Appellate Body Report, *US – Softwood Lumber IV*, para 99.

significant provider of the good in question.[810] In the exceptional circumstances singled out by the Panel, the Appellate Body's argumentation to apply other than in-country prices would *a fortiori* apply. If the government is the *sole* domestic provider or administratively controls all of those prices, other than in-country prices will indeed have to be used.[811] In *Canada – Dairy (Article 21.5 – New Zealand and US)*, the Appellate Body had, for instance, relied upon an alternative benchmark (i.e., production costs) since the domestic price was an administered price fixed by the Canadian government.[812] Overall, however, the Appellate Body stressed that the possibility to use an alternative benchmark is 'very limited' and should be determined on a 'case-by-case' basis.[813]

In these limited situations where other than in-country market prices could be used, how should such an alternative benchmark be constructed? Refraining to give a full overview, the Appellate Body only indicated that it would agree with benchmarks that would be based on world market prices or prices constructed on the basis of production costs.[814] As discussed in more detail below, production costs have already been used as benchmark in some disputes on agricultural export subsidies.[815] Yet, the Appellate Body warned that it must be ensured that such alternative prices are always related to market conditions in the country under investigation. Somehow, these prices will thus have to be adapted to reflect in-country market conditions such as 'price, quality, availability, marketability, transportation and other conditions of purchase or sale, as required by Article 14(d)'.[816]
Although the Appellate Body refrained from explicitly taking position due to lack of sufficient facts, it seemed to hint that it would not have easily agreed with USDOC's decision to use private market prices in another country (e.g., the US) as an alternative benchmark. After all, the Appellate Body considered it be 'very difficult, from a practical viewpoint', to adapt those prices to market conditions in the country of provision.[817] In any event, the use of

[810] Appellate Body Report, *US – Softwood Lumber IV*, para 102.
[811] Indeed, the Appellate Body expressed some difficulty with the Panel's approach of treating a situation in which the government is the sole supplier of certain goods differently from a situation in which the government is the predominant supplier of those goods because there would be little difference in terms of market distortion. Appellate Body Report, *US – Softwood Lumber IV*, para 100; see also above n 806.
[812] Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para 82.
[813] Appellate Body Report, *US – Softwood Lumber IV*, paras 99, 102.
[814] Appellate Body Report, *US – Softwood Lumber IV*, para 106.
[815] See also Appellate Body Report, *US – Softwood Lumber IV*, footnote 128. The Panel and Appellate Body also relied upon production costs as benchmark in *EC – Export Subsidies on Sugar* (see below Part II, Chapter 6, Section 6.2.1.2.1.1).
[816] Appellate Body Report, *US – Softwood Lumber IV*, para 106.
[817] The Appellate Body considered it difficult in practice 'for investigating authorities to replicate reliably market conditions prevailing in one country on the basis of market conditions prevailing in another country' because 'there are numerous factors to be taken into account in making adjustments'

this benchmark would require that foreign country market prices are adapted so that any comparative advantage of the prevailing country is respected. Indeed, the Appellate Body reasoned:

> (…) countervailing measures may be used only for the purpose of offsetting a subsidy bestowed upon a product, provided that it causes injury to the domestic industry producing the like product. They must not be used to offset differences in comparative advantages between countries.[818]

The Appellate Body's concern seems that foreign country market prices might be higher simply because the country under investigation has a comparative advantage in producing the good in question. Obviously, if such higher foreign country market prices would be used as benchmark, the price at which the country under investigation provides the good in question will be considered at subsidized terms even if such lower price merely reflects its comparative advantage. Unless foreign country prices are corrected for any difference in comparative advantage – which is a highly difficult exercise –, their use as point of comparison would thus lead to false positive determinations of subsidization. Albeit the Appellate Body's concern therefore seems legitimate, the dividing line between the legitimate use of CVDs for 'offsetting a subsidy' and their illegitimate use 'to offset differences in comparative advantage' seems hard to draw in practice. As illustrated in Part I, differences in comparative advantage could very well be *created* by subsidization.

Several scholars have aligned with the economic logic behind the US reasoning but have labeled the Appellate Body's finding to read this logic into Article 14(d) of the SCM Agreement as impermissible judicial activism.[819] On balance, the Panel's position seems indeed correct that such a reading would require a formal amendment to Article 14(d) of the SCM Agreement since its role is 'to explain what it means, not what in our view it should mean'.[820] In the Rules Negotiations, WTO Members have taken on the Panel's suggestion

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and 'it would be difficult to ensure that all necessary adjustments are made'. Appellate Body Report, *US – Softwood Lumber IV*, para 108.

[818] Appellate Body Report, *US – Softwood Lumber IV*, para 109. Interestingly, Canada had argued during the Uruguay Round that 'natural-resource pricing policies, because they related both to matters of national sovereignty as well as comparative advantage, were of fundamental importance to the contracting parties. (…) (T)he unilateral right to countervail (…) was not intended to be used to negate a country's general comparative advantage'. *Note by the Secretariat, Subsidies and Countervailing Measures* (MTN.GNG/NG10/W/4, 28 April 1987), at 27.

[819] Mavroidis, Messerlin, and Wauters, above above n 729, at 347; H. Horn and P. C. Mavroidis, 'United States – Final Determination with Respect to Certain Softwood Lumber from Canada (WT/DS257/AB/R: DSR 2004:II, 571; DSR 2004:II, 641)', in H. Horn and P. C. Mavroidis (eds), *The American Law Institute Reporters' Studies on WTO Case Law – Legal and Economic Analysis* (Cambridge: Cambridge University Press, 2007), 700-715, at 708-709.

[820] Panel Report, *US – Softwood Lumber IV*, para 7.60. Three aspects at the core of the Appellate Body's reading are indeed not convincing.

and proposed a formal amendment that would codify the principle that under certain circumstances an alternative benchmark could be used.[821] According to the Draft Consolidated Chair Text, the following new paragraph would be added to Article 14(d) of the SCM Agreement:

> Where the price level of goods or services provided by a government is regulated, the adequacy of remuneration shall be determined in relation to prevailing market conditions for the goods or services in the country of provision when sold at unregulated prices, adjusting for quality, availability, marketability, transportation and other conditions of sale; provided that, *when there is no unregulated price, or such unregulated price is distorted because of the predominant role of the government in the market as a provider of the same or similar goods or services*, the adequacy of remuneration *may* be determined by reference to *the export price* for these goods or services, or to a *market-determined price outside the country of provision*, adjusting for quality, availability, marketability, transportation, and other conditions of sale.[822]

This amendment would ensure that an alternative benchmark could only be constructed in the two factual situations that already came to the surface in the case law: in case prices are regulated prices or in case the government has a predominant role as a provider of the good in question, including when it is the sole provider. In those two situations, the adequacy of remuneration 'may' be determined by reference either to export prices or to market-

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First, the Appellate Body argued that the phrase 'in relation to' in Article 14(d) of the SCM Agreement should *not* be narrowly understood as 'in comparison with', like the Panel had read it, but refers more broadly to 'relation, comparison, reference'. This implies, according to the Appellate Body, that the benchmark chosen under Article 14(d) of the SCM Agreement should not strictly be made in 'comparison with' but only has 'to relate or refer to, or is connected with' the conditions prevailing in the market. Yet, I agree with Horn and Mavroidis (above n 819, at 708) that it is very questionable that such a broad reading would have been in the drafters' mind. On the other hand, the Appellate Body's reading is not, as Horn and Mavroidis seem to suggest, so broad that if this would have been in the drafters' mind, they would have used another phrase such as 'inter alia'. After all, there still needs to be a link to prevailing market conditions even in the Appellate Body's overly broad reading.

Second, the chapeau of Article 14 provides that any method used by an investigating authority in calculating benefit '*shall* be consistent with the (...) *guidelines*' (emphasis added) set out under paragraphs (a) through (d). According to the Appellate Body (paras 91-92), this indeed indicates that the calculation of the benefit consistent with the guidelines is mandatory. At the same time, it does not mandate 'using only one methodology for determining the adequacy of remuneration (…)'. This, in turn, implies that the term 'guidelines' suggests that paragraphs (a) through (d) should not be interpreted as 'rigid rules that purport to contemplate every conceivable factual circumstance'. Yet, like correctly revealed by Mavroidis, Messerlin, and Wauters (above above n 729, at 355), the Appellate Body hereby seems to confuse 'methods' and 'guidelines'. Indeed, the text clearly requires that any methodology chosen by a WTO Member (flexible aspect) respects the guidelines for determining the adequacy of remuneration (inflexible aspect). Here, consider that the Appellate Body also understood the term 'guidelines' as the 'framework within which this calculation *is to performed*' (para 92, emphasis added).

Third and finally, it is hard to read the previous two Appellate Body's interpretations in a mutually supportive way. Its broad reading of 'in relation to' (and all other aspects of its interpretation) clearly suggests that it considers that an alternative benchmark in case of a predominantly role of the government could be covered under Article 14(d) itself, whereas its reading of the *chapeau* would suggest that such factual situations would simply not be captured under the circumstances set out in Article 14(d) of the SCM Agreement.

[821] The Panel considered that 'if the Members feel the rules as laid down in the WTO Agreements do not address certain situations in what they consider to be a satisfactory manner, they should raise this issue during negotiations'. Panel Report, *US – Softwood Lumber IV*, para 7.60.

[822] Draft Consolidated Chair Text, above n 643 (emphasis added).

determined prices outside the country. In line with the current case law, both prices should be adjusted to in-country conditions before they could be used as alternative benchmark. Whereas their use seems not mandatory,[823] the construction of other proxies seems to be excluded. Hence, the use of production costs as suggested by the Appellate Body would appear not to be allowed. On the other hand, the use of foreign market-determined prices, upon which the Appellate Body had expressed reservations because of its difficult adaptability to in-country conditions, would explicitly be allowed as proxy.

3.2.1.2. Non-market economies

Two WTO Members, China and Vietnam, have made a commitment when they acceded allowing other WTO Members to rely more easily on other than in-country prices for identifying or calculating the benefit element in their CVDs or multilateral actions. To grasp this difference in treatment under the SCM Agreement, the concept and treatment of so-called ‘non-market economies’ (NME) has to be introduced shortly.

Because of the predominant role of the government in the economy, CVDs were traditionally not applied against such ‘non-market economies’ (NME). Instead, countries such as the US and EC only imposed anti-dumping duties as ‘unfair trade remedy’ instrument against imports from these NME. Here, they made use of (generally higher) third country prices instead of (lower) in-country prices to construct the normal value of the product because the government’s impact on in-country prices made these unreliable. Since the export price of the alleged dumped product was compared with this inflated benchmark, the NME methodology generally resulted in more positive dumping determinations and higher dumping margins. The dismissal of the CVDs instrument (and choice for the anti-dumping instrument with an alternative methodology) was thus explained by the fact that the government’s impact on the economy was considered so pervasive that it could simply not be distinguished from actions of private actors. Therefore, no adequate subsidy calculation could be made in the absence of a distinct private market.[824] Looking back at its practice since the 1980s, USDOC explained that:

> The Soviet-style economies at that time made it impossible to apply (the criteria to establish a countervailing duty) because they were so integrated as to constitute, in essence, one large

[823] This follows from the use of the verb ‘may’.
[824] With regard to the US, this was established by the US Court of Appeals in *Georgetown Steel Corp. v United States* (Judgment of 18 September 1986).

> entity. In such a situation, subsidies could not be separated out from the amalgam of government directives and controls.[825]

Hence, USDOC concluded that 'subsidies would have no meaning in such an economy' and therefore did not impose CVDs against NME. In 2006, however, the US changed this practice and launched its first CVDs investigation against China.[826] This move was considered justified because 'China's economy, though riddled with the distortions attendant to the extensive intervention of the PRC Government, is more flexible than these Soviet-style economies'.[827] At the same time, the significant role of the Chinese government in the economy still justified, according to USDOC, to uphold China's status as NME for its anti-dumping investigations. The same reasoning was applied to Vietnam, resulting in a first positive preliminary CVDs determination by USDOC in 2009.[828] Since the beginning of its new approach, the US has initiated a substantive number of CVDs investigations against China, resulting in at least ten cases in the effective imposition of CVDs measures. At the end of 2008, China challenged before the WTO USDOC's anti-dumping and CVDs determinations in several of those investigations. In this pending case, the panel will have to decide whether the US respected its WTO trade remedy obligations in light of China's commitments made at the time of accession.

Clearly, WTO trade remedy obligations do certainly not preclude CVDs (or multilateral) action against subsidization by countries having NME status for anti-dumping investigations.[829] Somewhat contrary, at the time China and Vietnam acceded to the WTO (in

[825] See *Memorandum for David M. Spooner, CVD Investigation of Coated Free Sheet Paper from the People's Republic of China – Whether the Analytical Elements of the Georgetown Steel Opinion are Applicable to China's Present-Day Economy* (29 March 2007).

[826] On the discussion in the EC to likewise change its practice, see J. Cornelis, 'Applying Countervailing Duty Law to Non-market Economies – Will the EC Follow the US Example?', 2:11/12 *Global Trade and Customs Journal* (2007), 421-424.

[827] See *Memorandum for David M. Spooner,* above n 825. This was accepted by the US Court of International Trade (ITC), see below n 829.

[828] For an extensive discussion, see D. A. Gantz, 'Non-Market Economy Status and US Unfair Trade Actions Against Vietnam', *Arizona Legal Studies – Discussion Paper* (December 2009), 35 pp.

[829] The only prohibition is that imported products cannot 'be subject to both anti-dumping and countervailing duties to compensate for the same situation of dumping or export subsidization' (Article VI.5 of the GATT). One of the pivotal questions before the Panel is whether USDOC's methodology respected this obligation and did not result in double-counting by applying parallel anti-dumping duties and CVDs. Note in this respect that the US Court of International Trade (ITC) has already found that USDOC's methodology indeed results in double-counting. It concluded that:

> 'Commerce is not barred by statutory language from applying the CVD law to imports from the PRC, but that Commerce's current interpretation of the NME AD statute in relation to the CVD statute here was unreasonable. If Commerce is to apply CVD remedies where it also utilizes NME AD methodology, Commerce must adopt additional policies and procedures for its NME AD and CVD methodologies to account for the imposition of the CVD law to products from an NME country and avoid to the extent possible double counting of duties'.

United States Court of International Trade, *GPX International Tire Corporation et al. v. United States* (18 September 2009, Slip. Op. 09-103).

2001 and 2007, respectively), other WTO Members explicitly preserved their right to treat these countries as NME for anti-dumping purposes, whereas they inscribed more flexibility to take action against both governments' interventions under the SCM Agreement.[830] First, concerning anti-dumping duties, other WTO Members obtained temporary allowance (at most until 2016 with regard to China and 2018 with regard to Vietnam) to use other than in-country prices if producers fail to demonstrate that market conditions prevail in their industry.[831] Second and more relevant for our discussion, both countries have also given more leeway to other WTO Members to rely upon alternative benchmarks in their benefit analysis and calculation. Indeed, one of China's commitments in its Protocol of Accession is that:

> In proceedings under Parts II, III and V of the SCM Agreement, when addressing subsidies described in Articles 14(a), 14(b), 14(c) and 14(d), relevant provisions of the SCM Agreement shall apply; however, if there are *special difficulties* in that application, the importing WTO Member may then use methodologies for identifying and measuring the subsidy benefit which take into account the possibility that prevailing terms and conditions in China may not always be available as *appropriate benchmarks.* In applying such methodologies, *where practicable*, the importing WTO Member should adjust such prevailing terms and conditions before considering the use of terms and conditions prevailing outside China.[832]

In somewhat similar terms, Vietnam accepted that:

> In proceedings under Parts II, III and V of the SCM Agreement, when addressing subsidies, the relevant provisions of the SCM Agreement shall apply; however, if there are *special difficulties* in that application, the importing WTO Member may then use alternative methodologies for identifying and measuring the subsidy benefit which take into account the possibility that prevailing terms and conditions in Viet Nam may not be available as *appropriate* benchmarks.[833]

Thus, WTO Members taking CVDs or multilateral action against China or Vietnam could make use of other than in-country prices as benchmark if 'special difficulties', which arguably have to relate to the dominant role of the government, would prevent the use of the normal benchmarks stipulated under Article 14 of the SCM Agreement.[834] In case of China, recourse to foreign country prices could only be taken if the WTO Member has, 'where practicable',

[830] These commitments are an integral part of the WTO Agreement and thus enforceable in the WTO dispute settlement procedures. See Appellate Body Report, *China – Audiovisual Services*, para 133; Panel Report, *China – Auto Parts*, paras 7.740-7.741. See *China's Protocol of Accession* (WT/L/432, 23 November 2001); *Vietnam's Protocol of Access* (WT/L/662, 15 November 2006); *Report of the Working Party on the Accession of Viet Nam* (WT/ACC/VNM/48, 27 October 2006), paras 255, 527.

[831] *China's Protocol of Accession* (WT/L/432, 23 November 2001), para 151, item (a),(c),(d*); Report of the Working Party Report on the Accession of China* (WT/ACC/CHN/49), para 151; *Report of the Working Party on the Accession of Viet Nam* (WT/ACC/VNM/48, 27 October 2006), para 255, items (a), (c),(d).

[832] *China's Protocol of Accession* (WT/L/432, 23 November 2001), para 151, item (b) (emphasis added).

[833] *Report of the Working Party on the Accession of Viet Nam* (WT/ACC/VNM/48, 27 October 2006), para 255, item (b) (emphasis added).

[834] These methodologies have to be notified to the SCM Committee. *China's Protocol of Accession* (WT/L/432, 23 November 2001), para 151, item (c); *Report of the Working Party on the Accession of Viet Nam* (WT/ACC/VNM/48, 27 October 2006), para 255, item (c).

explored the option to adjust prevailing terms and conditions in China. One of the pivotal questions that the Panel will have to tackle in the pending case is how much more leeway is given under these vaguely formulated commitments to use alternative benchmarks than under the rather strict *US – Softwood Lumber* jurisprudence sketched out above. To be sure, these commitments regarding the SCM Agreement are not dependent on whether or not NME status under anti-dumping investigations is still applied. Whereas the latter right is subject to extinction, the commitments on benefit identification and calculation are not explicitly limited in time.[835]

3.2.2. Determination of the relevant recipient

It has been explained that the benefit analysis focalizes on the recipient of the financial contribution (or income/price support). This recipient could be 'a legal or natural person, or a group of persons'.[836] Yet, the Appellate Body in *US – Countervailing Measures on Certain EC Products* further clarified that the recipient of the benefit might be different from the recipient of the financial contribution and that a benefit might be received by different recipients.[837] The beneficiaries of a financial contribution could thus include a firm (legal person) and its owners (natural persons) at the same time. For instance, the Appellate Body observed that:

> (A) transfer of funds could be provided directly from the government to the legal person that is the producer of the subsidized product, or it could be provided indirectly, say, through an income tax concession to the natural persons that own the firm (inasmuch as they invest in the legal person's productive activities).[838]

In light of this and related case law, two further specifications on the identification of the beneficiary under Article 1.1(b) of the SCM Agreement should be articulated.

First, the focus of the 'benefit' analysis is on legal or natural persons instead of on their productive operations.[839] It is therefore not required to demonstrate that a financial contribution to a firm or its owners effectively affects the firm's productive operations. Read together with the interpretation of the relevant market benchmark, this implies that the benefit analysis does not merely single out those financial contributions that effectively improve a firm's competitive position.[840]

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[835] *China's Protocol of Accession* (WT/L/432, 23 November 2001), para 151, items (b),(d); *Report of the Working Party on the Accession of Viet Nam* (WT/ACC/VNM/48, 27 October 2006), para 255, items (b),(d).
[836] Appellate Body Report, *Canada – Aircraft*, para 154.
[837] Appellate Body Report, *US – Countervailing Measures on Certain EC Products*, para 110.
[838] Appellate Body Report, *US – Countervailing Measures on Certain EC Products*, para 113.
[839] Appellate Body Report, *US – Lead and Bismuth II*, paras 56-58; Appellate Body Report, *US – Countervailing Measures on Certain EC Products*, para 110.
[840] For a discussion, see below Part IV, Chapter 1, Section 1.2.

Second, only the *existence* of a benefit to the recipient and not the exact amount of such benefit should be demonstrated to pass the threshold of Article 1.1(b) of the SCM Agreement.[841] The quantification of the exact benefit amount only becomes relevant for deciding on the appropriate CVDs level given that CVDs could not surpass the level of subsidization.[842] In contrast, the exact benefit upon the recipient should not be calculated for multilateral claims against subsidization.

In sum, a financial contribution might thus potentially benefit many different recipients (i.e., legal and/or natural persons) and only the existence of a benefit should be demonstrated under Article 1.1(b) of the SCM Agreement. Yet, the *direct recipient* of the financial contribution is not always the appropriate focus of the benefit analysis.[843] For example, in case of official export credit support, the relevant question is whether such support is beneficial to the *exporter* and not whether it is beneficial to the foreign purchaser receiving such an officially supported export credit.[844] As will be illustrated in the case study on export credit support (see below Part III), such pass through of the benefit to the exporter will be rather easily established since this is in principle inherent in the export credit support transaction itself. More difficult is the question whether a benefit is 'passed through' to the buyer in case he has freely negotiated the price of a previously subsidized good or asset. Has the subsidy in whole or in part passed through to the buyer? This hard question is addressed in two sorts of cases, namely so-called 'pass through cases', involving CVDs imposed on final products that have used subsidized inputs, and 'privatization cases', involving CVDs imposed on products

[841] See, for example, Appellate Body Report, *US – Upland Cotton*, para 462; Panel Report, *Mexico – Olive Oil*, paras 7.151-1.152.

[842] Article VI:3 of the GATT, Article 10, footnote 36 of the SCM Agreement; Panel Report, *Mexico – Olive Oil*, para 7.145. Arguably, the benefit amount is also relevant under Article 11.9 of the SCM Agreement (*de minimis* level of subsidization) (see below Part II, Chapter 5, Section 5.2.1.1).

[843] Reflecting upon the above-mentioned Appellate Body's statements in *US – Countervailing Measures on Certain EC Products* (above n 837), the Panel in *Mexico – Olive Oil* (para 7.152) suggested that the relevant recipient should not be specified:

> '(I)t is not necessary to identify the particular recipient or recipients of the benefit and the particular manner in which a subsidy is bestowed in order to determine that a benefit has been conferred, and that therefore a subsidy exists, within the meaning of Article 1.1(b)'.

In my view, the Panel hereby read too much into the Appellate Body's holdings. Its conclusion could simply not be inferred from the Appellate Body's summarized findings. Further, its interpretation is at odds with other case law which considered that the existence of a benefit upon the relevant entity should very well be identified under Article 1 of the SCM Agreement. For example, the Appellate Body in *US – Softwood Lumber IV* was very clear that, by virtue of Article 1 of the SCM Agreement, the 'investigating authority must (…) also establish that the benefit resulting from the subsidy has passed through, at least in part, from the input downstream, so as to *benefit* indirectly the processed product to be countervailed'. Appellate Body Report, *US – Softwood Lumber IV*, para 142 (emphasis in the original).

[844] Panel Report, *Brazil–Aircraft (Article 21.5 – Canada II)*, paras 5.27-5.28. In *Canada – Aircraft*, Brazil also argued that EDC's financial contributions were beneficial to Canadian exporters (Panel Report, *Canada – Aircraft*, paras 9.183 and 9.247).

produced in previously subsidized state-owned entities.[845] Both types of cases are addressed in the following sections.

3.2.2.1. Pass-through of benefit

Suppose that a subsidy in the meaning of the SCM Agreement is given to upstream producers but that an investigating authority aims at imposing CVDs on products of downstream producers. Should the CVDs-investigating authority demonstrate that the benefit conferred by the subsidy upon upstream producers was 'passed through' to unrelated downstream producers or could this simply be assumed? As the case law currently stands, a 'pass through' analysis should, under certain circumstances, be undertaken by virtue of the prohibition to impose CVDs *in excess* of the amount of the total subsidy accruing to that product (Article VI:3 of the GATT and 10 of the SCM Agreement).

Under the GATT era, the GATT Panel in *US – Canadian Pork* had already found that, in order to impose CVDs on pork, USDOC had to demonstrate that the subsidy to swine producers (upstream) was passed through to pork producers (downstream) because the pork and swine industries were separate and operated at arm's length.[846] Under such circumstances, 'the subsidies granted to swine producers could be considered to be bestowed on the production of pork *only if* they had led to a decrease in the level of prices for Canadian swine paid by Canadian pork producers below the level they have to pay for swine from other commercially available sources of supply'.[847] The idea is thus that, if the price of a transaction is determined by negotiations between unrelated producers (i.e., the transaction is made at arm's length), it might happen that the subsidy upon the upstream producer (i.e., swine producers) is not, or only to a lesser extent, reflected in a lower price charged to downstream producers (i.e., pork). A pass-through analysis would have to reveal whether the price paid by the downstream producer for the input (i.e., swine) was effectively lower than the market price, and thus whether he would indirectly benefit from the subsidy offered to upstream producers. If a market price would have been paid, the downstream producer does

[845] As will be illustrated in Part IV, the pass-through of the benefit to the new owner in case of privatization also seems inherent in the transaction itself but this is not recognized in the case law (see below Part IV, Chapter 1, Section 1.2.2).

[846] Transactions between unrelated actors are, by definition, at arm's length (see also below n 878). Obviously, a transaction at arm's length does not does imply that the negotiated price corresponds to the market price. The question whether this occurs is exactly the object of the pass-through analysis.

[847] Panel Report, *US – Canadian Pork*, para 4.9 (emphasis added). Hence, the following US practice, as summarized by the Panel in *Mexico – Olive Oil*, was considered inconsistent with Article VI:3 of the GATT insofar it related to separate industries that operated at arm's length:

> 'Under US law at the time, subsidies provided to the producers of a raw agricultural product were deemed to be provided in respect of production of processed products made from the raw products if the demand for the raw product was "substantially dependent" on the demand for the processed product and the processing operation added only limited value to the raw product'.

Panel Report, *Mexico – Olive Oil*, para 7.134.

not benefit from the subsidy because he would have paid the same price for its inputs when he would have bought it from other upstream producers.

In the WTO era, the *US – Softwood Lumber IV* case confronted the WTO-adjudicating bodies with a similar question. As explained above, Canada had offered a financial contribution in the form of the provision of a good by granting the right to harvest 'standing timber' (i.e., stumpage) at terms alleged to be beneficial to harvesters.[848] When such *stumpage* was harvested, these *logs* were further processed into *primary lumber* by sawmills. Part of such lumber was then further processed by independent remanufactures into *remanufactured lumber*. USDOC had applied CVDs on primary and remanufactured *lumber* on the basis of a determination that stumpage had been subsidized. It had not assessed whether the benefit was effectively passed through to independent (i.e., not vertically integrated) lumber processing producers. Figure 2 clarifies the different situations on how the processing of standing timber into lumber ($\text{lumber}_{\text{PRIM}}$ and $\text{lumber}_{\text{REMAN}}$) was undertaken. Notice hereby that the four identified producers operated at arm's length and that the alleged subsidy was given to stumpage.

Along the lines set out by the GATT Panel in *US – Canadian Pork*, the Appellate Body decided that:

> Where countervailing duties are used to offset subsidies granted to producers of input products, while the duties are to be imposed on *processed* products, and where input producers and downstream processors operate at *arm's length*, the investigating authority must establish that the benefit conferred by a financial contribution directly on input producers is passed through, at least in part, to producers of the processed product subject to the investigation.[849]

In absence of such pass-through determination, the Appellate Body underlined that 'it cannot be shown that the essential elements of the subsidy definition in Article 1 are present in respect of the *processed product*'.[850] At the same time, the Appellate Body recognized that WTO Members are by virtue of Article 19 of the SCM Agreement authorized to perform an investigation on an *aggregate* basis. This right implies that CVDs could be imposed on imports from producers or exporters not investigated individually.[851]

[848] On the question whether it was beneficial to timber harvester, see above Part II, Chapter 3, Section 3.2.1.1.
[849] Appellate Body Report, *US – Softwood Lumber IV*, para 141.
[850] Appellate Body Report, *US – Softwood Lumber IV*, para 143 (emphasis in the original).
[851] Appellate Body Report, *US – Softwood Lumber IV*, para 154. See below Part II, Chapter 5, Section 5.2.3.

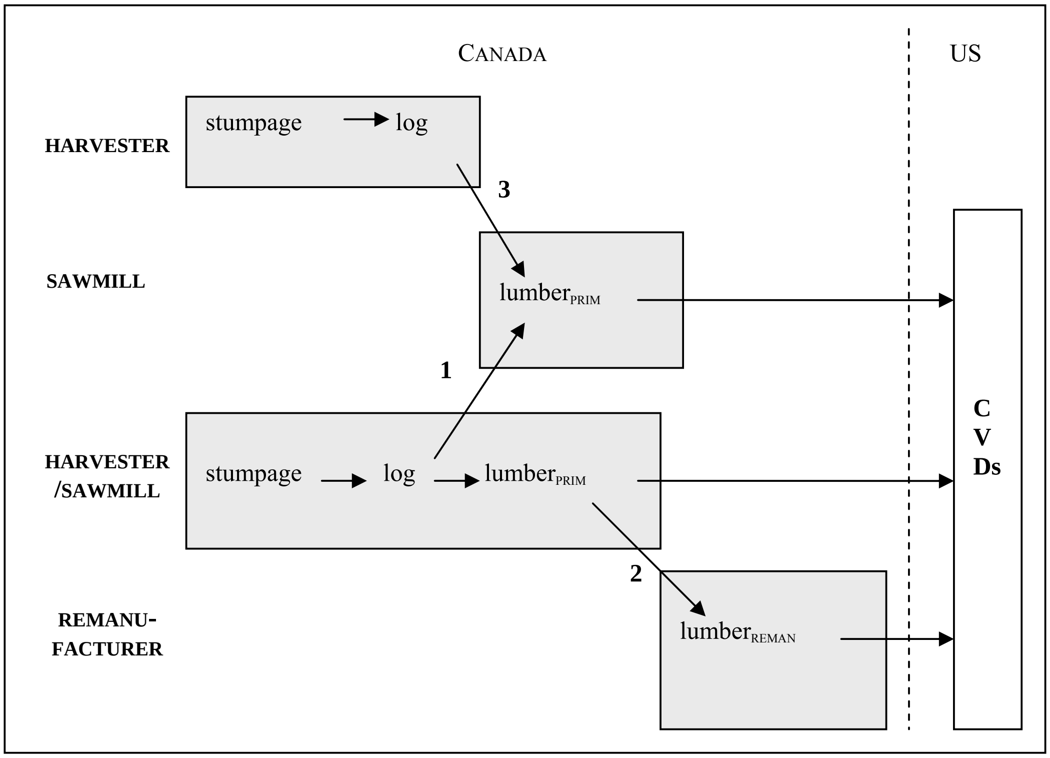

FIGURE 2: PRODUCTION PROCESS SOFTWOOD – LUMBER IV

Turning to the facts of the case[852], the Appellate Body decided that, with regard to *situation 1* (see Figure 2),[853] the US should have undertaken a pass-through analysis because the sales transaction between the harvester/sawmill producer and unrelated sawmill producers concerned a product (in this case logs) not subject to the investigation.[854,855] With regard to *situation 2*[856], however, the Appellate Body concluded that, by virtue of USDOC's right to conduct an *aggregate* investigation, no pass-through analysis was required since the transaction concerned a product (in this case lumber$_{PRIM}$) subject to the investigation.[857]

[852] With regard to *situation 3*, whereby harvesters sell logs to an independent sawmill for further processing into lumber$_{PRIM}$, the US had acknowledged that a pass-through analysis was required but it had not done so because these transactions were insignificant.
[853] This concerned the situation where a tenured timber harvester owns a sawmill and processes some of the logs it harvests into lumber$_{PRIM}$, but, at the same time, sells at arm's length some of the logs it harvests to other, unrelated sawmills for further processing into lumber$_{PRIM}$.
[854] Only lumber$_{PRIM}$ and lumber$_{MAN}$ were subject to the investigation.
[855] The Appellate Body agreed 'in the abstract, that a transfer of benefits from logs sold in arm's length transactions to lumber produced in-house from different logs *is possible* for a harvester that owns a sawmill' but this could not be assumed. Appellate Body Report, *US – Softwood Lumber IV*, para 157 (emphasis in the original).
[856] This concerned the situation where the tenured timber harvesters that own or are related to sawmills (sawmill/harvesters) process the logs they harvest into lumber$_{PRIM}$ and sell this lumber to unrelated remanufactures for further processing into lumber$_{MAN}$.
[857] After all, the Appellate Body reasoned:

> 'Once it has been established that benefits from subsidies received by producers of *non-subject* products (that is, inputs) have passed through to producers of *subject* products (primary and

Importantly, such a pass-through investigation should under those circumstances not be undertaken *if* CVDs-investigating authorities effectively conduct an *aggregate* investigation. The Appellate Body acknowledged that its conclusion might very well lead to CVDs on processed products (in this case $\text{lumber}_{\text{REMAN}}$) not subsidized at all, 'especially if the remanufacturer purchased the primary lumber it processed at arm's length'.[858] Yet, it considered that this result is inherent in the right of Members to conduct an aggregate investigation. Importantly, exporters (in this case remanufactures) not investigated individually in an aggregate investigation have the right on a review procedure in order for an individual CVDs rate to be established. In such a review process, the Appellate Body stressed, it would be 'likely' that a pass-through analysis would be required to determine that a benefit was also passed through to the processed product (in this case from $\text{lumber}_{\text{PRIM}}$ inputs to $\text{lumber}_{\text{REMAN}}$).[859] In sum, the Appellate Body did not fundamentally confine the situations in which a pass-through analysis has to be conducted.

Summarizing this case law, the Panel in *Mexico – Olive Oil* concluded that a pass-through analysis is required when two conditions are present simultaneously: '(1) a subsidy is provided in respect of a product that is an input into the processed, imported product that is the subject of the countervail investigation; and (2) the producer of the input product and the producer of the imported product subject to the countervail investigation are unrelated'.[860] If the input producer and the processed product producer are *related* (i.e., vertically integrated), the pass-through of a benefit could thus be assumed.[861] On the other hand, the set of two conditions likewise implies, contrary to what the EC had advocated, that a pass-through analysis should not be conducted whenever the second condition is fulfilled, i.e., whenever there is *any* arm's length transaction between unrelated companies.[862,863] The Panel spelled out a hypothetical example illustrating why it could not agree with the EC's view:

> remanufactured softwood lumber), we do not see why a further pass-through analysis *between* producers of subject products should be required in an investigation conducted on an aggregate basis. In this situation, it is not necessary to calculate precisely how subsidy benefits are divided up between the producers of subject products (…)'.

Appellate Body Report, *US – Softwood Lumber IV*, para 154.

[858] The Appellate Body emphasized the important difference between an individual and collective investigation regarding the calculation of the appropriate CVDs amount (see below n 1546). See Appellate Body Report, *US – Softwood Lumber IV*, para 164, footnote 196.

[859] Appellate Body Report, *US – Softwood Lumber IV*, para 164.

[860] Panel Report, *Mexico – Olive Oil*, para 7.142.

[861] Similar to the general benefit benchmark, it is, however, not established that the competitive position of the downstream producer has improved as a result of subsidization.

[862] The Panel reasoned that, if this is not required for certain arm's length sales of *inputs* between unrelated firms, as the Appellate Body had found in *US – Lumber IV*, 'then *a fortiori* the mere existence of an arms'-length transaction between firms involving the product under investigation somewhere between the receipt of the subsidy and the export of the merchandise should not, by itself,

> Taking the simplest hypothetical example, where a subsidy is provided directly to a producer of a product coming within the scope of a countervailing duty investigation, we do not see how that company's eventual sale of the product to an unrelated firm (e.g., a distributor) would have a bearing on the fact that a subsidy has been bestowed in respect of the "production" of that product.[864]

Deciding otherwise, the Panel continued, would mandate a pass-through analysis 'in almost every countervail investigation, even when the subsidy was provided directly on the investigated product'.[865] A relevant but open question is whether the Panel's conclusions are, like the finding by the Appellate Body in *Canada – Softwood Lumber IV*, also confined to *aggregate* CVDs investigations.[866]

The Panel not only rejected the EC's argument on a substantive level but likewise found that the EC wrongly based its argument on Articles 1.1(b) of the SCM Agreement.[867] Because the EC did not question the *existence* of any benefit but only alleged that the *amount* was not properly calculated,[868] the failure to conduct a pass-through analysis could not be based on Article 1.1(b) of the SCM Agreement. Instead, such claim had to be based on Article VI:3 of the GATT and/or Article 10 of the SCM Agreement. These provisions mandate that CVDs could not be imposed above the level of subsidies. I concur with this conclusion but for another, more fundamental reason: a government measure (e.g., CVDs investigation) cannot be *inconsistent* with Article 1 of the SCM Agreement on itself as the EC had claimed. Indeed, Mexico correctly explained that this opening provision of the SCM Agreement 'only establishes, in a conceptual way, which elements must be present in order to determine that a

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give rise to an obligation to conduct a pass-through analysis'. Panel Report, *Mexico – Olive Oil*, para 7.143.

[863] Regarding the facts of the case, the EC had argued that Mexico should have demonstrated that subsidies to *olive growers*, producing a very basic version of olive oil, were passed through to *olive oil exporters*, who further processed the crude olive oil before exporting. Yet, the Panel concluded that Mexico had made a reasonable case that the subsidy to olive growers was not provided on an input product (in this case olives) but on their production of the product under investigation itself (in this case olive oil) and, therefore, no pass-through analysis was required. Panel Report, *Mexico – Olive Oil*, para 7.168.

[864] Panel Report, *Mexico – Olive Oil*, para 7.144.

[865] Panel Report, *Mexico – Olive Oil*, para 7.144.

[866] When discussing the Appellate Body report, the Panel recalled that 'the situation in that investigation, as in the one that is the subject of the present dispute, was that the per unit subsidy amount was established on an aggregate, country-wide basis'. See Panel Report, *Mexico – Olive Oil*, para 7.140 (footnote 180) and paras 6.22, 7.168. However, its general interpretations on when a pass-through analysis should (not) be conducted were not explicitly confined to aggregate investigations.

[867] The EC also argued that Mexico failed to respect Article 14 of the SCM Agreement but this was also rejected by the Panel, partly because the financial contribution at issue (i.e., grant) is not listed under Article 14 of the SCM Agreement. See Panel Report, *Mexico – Olive Oil*, paras 7.154-7.169.

[868] However, the Panel failed to clarify whether the EC indeed acknowledged that some benefit was passed through to *olive oil exporters* or merely agreed that a benefit upon *olive growers* existed. See Panel Report, *Mexico – Olive Oil*, para 7.150 (see above n 866).

subsidy exists'.[869] The Panel, however, explicitly disagreed with this reasoning. If CVDs are imposed upon financial contributions not conferring a benefit, the Panel considered that 'the investigated measure would not constitute a subsidy, and application of a countervailing duty would be *inconsistent* with Article 1.1 of the SCM Agreement'.[870] So, in line with the Panel in *EC – Countervailing Measures on DRAM Chips*,[871] the Panel in *Mexico – Olive Oil* considered that government measures could be inconsistent with Article 1 of the SCM Agreement *as such* and thus that a claim could be solely based on this provision. From a conceptual stance, I have to disagree with this interpretation.[872]

The substantive aspects of this case law have also found their way to the Doha negotiations. Indeed, according to the Draft Consolidated Chair Text, a new paragraph relevant to CVDs investigations would be added to Article 14 of the SCM Agreement:

> Where a *subsidy is granted in respect of an input used to produce the product under consideration*, and the producer of the product under consideration is *unrelated* to the producer of the input, no benefit from the subsidy in respect of the input shall be attributed to the product under consideration unless a determination has been made that the producer of the product under consideration obtained the input on terms more favourable than otherwise would have been commercially available to that producer in the market.[873]

The obligation to conduct a pass-through analysis would thus be triggered if the two elements disentangled by the Panel in *Mexico – Olive Oil* would be present: (1) a subsidy is granted in respect of an input used to produce the product under consideration and (2) the producer of the product under consideration is unrelated to the input producer. In that case, a CVDs-investigating authority is, similar as under the general market benchmark, required to assess whether the processing producer has received the input at better-than-market terms.[874] If a market price would have been charged, no pass-through of any benefit would have taken place. In line with the case law on the relevant benchmark,[875] it is foreseen that the very same subsidy might distort such private prices and thus undermine their relevance as benchmark:

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[869] Panel Report, *Mexico – Olive Oil*, para 7.129.
[870] Panel Report, *Mexico – Olive Oil*, para 7.149 (emphasis added).
[871] Panel Report, *EC – Countervailing Measures on DRAM Chips*, paras 7.186, 8.1.
[872] In my understanding, the following Appellate Body's reasoning is more accurate:

> 'In the absence of (a pass through analysis), it cannot be shown that the essential elements of the subsidy definition in *Article 1* are present in respect of the processed product. In turn, the right to impose a countervailing duty on the processed product for the purpose of offsetting an input subsidy, would not have been established in accordance with *Article VI:3 of the GATT 1994*, and, consequently, would also not have been in accordance with *Articles 10 and 32.1 of the SCM Agreement*'.

Appellate Body Report, *US – Softwood Lumber IV*, para 143 (emphasis added).
[873] Draft Consolidated Chair Text, above n 643 (emphasis added).
[874] This is also in line with the test articulated by the GATT Panel in *US – Canadian Pork* (see above n 847).
[875] See above Part II, Chapter 3, Section 3.2.2.1.

> Where, however, it has been established that the effect of the subsidy is so substantial that other relevant prices available to the producer of the product under consideration are distorted and do not reasonably reflect commercial prices that would prevail in the absence of the subsidization, other sources, such as world market prices, can be used as the basis for the determination in question.

If the subsidy is 'so substantial' that private market prices are distorted and these prices do not 'reasonably reflect commercial prices', the threshold to use an alternative benchmark would already be met. In that case, one potential alternative benchmark is suggested (i.e., world market prices) but other options would be allowed as well. Apparently, no requirement to adapt such an alternative benchmark to local conditions is explicitly foreseen.

3.2.2.2. Privatization of a subsidized enterprise

Does privatization of a firm at arm's length and for fair market value extinguish the continued existence of a benefit derived from a non-recurring (i.e., one time) financial contribution prior privatization? Put otherwise, does the privatized firm still enjoy a benefit in the meaning of Article 1.1(b) of the SCM Agreement? In *US – Countervailing Measures on Certain EC Products*, the Appellate Body somewhat altered its previous stance on this complex issue.

To grasp this case law, it should be explained that the benefits of non-recurring subsidies are often allocated over a period of time, which is 'normally presumed to be the average useful life of assets in the relevant industry'.[876] Observing agreement among both parties (EC and US) that such allocation is normal and accepted practice, the Appellate Body in *US – Countervailing Measures on Certain EC Products* found such 'useful life' practice permissible under the SCM Agreement insofar the presumption is not irrebuttable.[877] For instance, if the government has financed at favourable terms the acquisition of a machine with 'utility value' of ten years, the benefit of such subsidy under the 'useful life' approach would be spread over ten years. The core legal issue at stake was whether such allocation over a period of time is interrupted by privatization at arm's length and for fair market value.[878] The Appellate Body explained its approach as follows:

[876] Appellate Body Report, *US – Countervailing Measures on Certain EC Products*, para 12, footnote 23. The benefits of recurring subsidies are usually considered fully absorbed in the year of receipt. See, for example, *Paper by Brazil, Allocation of Subsidy Benefits* (TN/RL/W/192, 23 November 2005), para 4.

[877] Appellate Body Report, *US – Countervailing Measures on Certain EC Products*, para 84; Appellate Body Report, *US – Lead and Bismuth II*, para 62; see also Panel Report, *Japan – DRAMS Countervailing Duties,* para 7.360.

[878] At *arm's length* means that transaction (in this case privatization) is 'negotiated between unrelated parties, each acting in their own interest, or between related parties such that the terms of the transaction are those that would exist if the transaction had been negotiated between unrelated parties'. The *fair market value* test examines whether the purchaser paid 'the full amount that the company or its assets (including the value of any subsidy benefits) were actually worth under the prevailing market

> (F)ollowing privatization, the *utility value* of equipment acquired as a result of a financial contribution is not extinguished, because it is transferred to the newly-privatized firm. But, the *utility value* of such equipment to the newly-privatized firm is legally irrelevant for purposes of determining the continued existence of a "benefit" under the *SCM Agreement*. As we found in *Canada – Aircraft*, the value of the "benefit" under the *SCM Agreement* is to be assessed using the *marketplace* as the basis for comparison. It follows, therefore, that once a fair market price is paid for the equipment, its *market value* is redeemed, regardless of the utility the firm may derive from the equipment. Accordingly, it is the *market value* of the equipment that is the focal point of analysis, and not the equipment's *utility value* to the privatized firm.[879]

Accordingly, the Appellate Body acknowledged that the *utility* value of the equipment acquired at subsidized terms does not extinguish as a result of privatization. Yet, it simply considered this element irrelevant under the benefit analysis because this test looks at the *market* value as benchmark: if a fair market value is paid at the moment of privatization, 'the *market value* is redeemed' and the benefit thus, in principle, extinguishes. The idea as articulated by the Panel in the same case is that the value of the continuing benefit is reflected in the fair market price and, as a result, fully paid for by the privatized producer: he does not enjoy a benefit in wealth terms from the previous subsidization as he paid a market price for it.[880,881] Deviating from prior case law in *US – Lead and Bismuth II*, the Appellate Body decided that a fair market price does not *necessarily* extinguish prior subsidization.[882] In reasonably competitive markets, 'the actual exchange value' of the continuing benefit will be fairly reflected in the market price and the benefit will indeed extinguish.[883] But governments might not always be price takers in the process of privatization since they could, by designing economic and other policies, 'influence the circumstances and the conditions of the sale so as to obtain a certain market valuation of the enterprise'.[884] Because such 'induced' market valuation could differ from the fair market value, the benefit of past non-recurring subsidies could continue after privatization. Regrettably, the Appellate Body did not offer any

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conditions'. Definitions applied under US CVDs procedure, as cited in Panel Report, *US – Countervailing Measures on Certain EC Products (Article 21.5 – EC)*, para 7.89, footnote 313.

879 Appellate Body Report, *US – Countervailing Measures on Certain EC Products*, para 102 (emphasis in the original).

880 Panel Report, *US – Countervailing Measures on Certain EC Products*, footnote 333 and paras 7.72-7.76.

881 The Panel also understood that market distortions created by prior subsidization might very well remain in place after privatization at arm's length and for fair market value but likewise considered this irrelevant under the 'benefit' analysis of the SCM Agreement. In the words of the Panel:

> '(C)ountervailing duties are not designed to counteract all market distortions or resource misallocations which might have been caused by subsidization. For the purpose of determining the existence of a benefit under the SCM Agreement, it is irrelevant whether or not any potential market distortions resulting from the prior subsidy remain after the privatization at arm's-length and for fair market value'.

Panel Report, *US – Countervailing Measures on Certain EC Products*, para 7.80.

882 The Panel had followed the interpretation of the Appellate Body in *US – Lead and Bismuth II* and thus decided that a benefit could never continue after privatization at arm's length and for fair market value. Panel Report, *US – Countervailing Measures on Certain EC Products*, paras 7.72-7.91.

883 Appellate Body Report, *US – Countervailing Measures on Certain EC Products*, paras 122 and 124.

884 Appellate Body Report, *US – Countervailing Measures on Certain EC Products*, para 124.

illustration on what it had exactly in mind.[885] Anyway, the Appellate Body concluded that privatization at arm's length and for fair market value only *presumes* extinction of any benefit attached to past non-recurring financial contributions.[886] In Part IV, the fundamental criticism articulated by Grossman and Mavroidis on this privatization case law is examined in detail.[887] This fits in their broader criticism on the benefit-concept developed in the case law and explained in this section.

The two constitutive elements of the subsidy definition as stipulated in Article 1 of the SCM Agreement have thus been explored: a government offers a subsidy if it makes a financial contribution (or income/price support) that confers a benefit upon the recipient. In the next section, the focus shifts to the 'specificity' element elaborated under Article 2 of the SCM Agreement.

3.3. SPECIFICITY

Specificity, as defined in Article 2 of the SCM Agreement, is not a constitutive element of a subsidy but a necessary condition for subsidies to be subject to the disciplines of the SCM Agreement.[888] Accordingly, non-specific subsidies are non-actionable under the SCM Agreement and can also not be countervailed.[889] Only financial contributions, or income/price support, that benefit a *specific* recipient are covered under the substantive disciplines of the SCM Agreement.

3.3.1. The rationale for the specificity test

It is not self-evident why this specificity test is included in the SCM Agreement. Broadly speaking, three different reasons could be distinguished. First, the World Trade Report 2006 endorsed an economic rationale:

> The approach in the legal texts towards "specificity" reflects the expectation that subsidies carry the potential to be more trade distorting the more specific they are. Indeed, in economic

[885] For example, to what extent could the 'fair market' assumption, which is the point of departure of the analysis, still be considered fulfilled?
[886] Appellate Body Report, *US – Countervailing Measures on Certain EC Products*, paras 126-127.
[887] See below Part IV, Chapter 1, Section 1.2.2.1.
[888] Article 1.2 of the SCM Agreement. See, for example, Appellate Body, *Softwood – Lumber IV*, para 72.
[889] Concerning non-actionable subsidies, this was confirmed by Article 8.1(b) of the SCM Agreement, indicating that non-specific subsidies fell into the category of 'non-actionable subsidies'. Moreover, non-specific subsidies were in any case non-actionable, in contrast to other non-actionable subsidies (Article 9.1 only refers to Article 8.1(a)). However, pursuant to Article 31 of the SCM Agreement, the category of non-actionable subsidy expired at the end of 1999. Nevertheless, non-specific subsidies are still non-actionable, simply because only specific subsidies can be actionable subsidies by virtue of Article 1.2 of the SCM Agreement.

> terms the more closely targeted a subsidy towards its intended beneficiaries, the more concentrated its relative price effect will tend to be. In many circumstances, this could be taken to imply a higher probability that the subsidy is distorting. A subsidy to a single industry, for example, rather than to many industries could impart a narrow advantage. The more broadly based subsidy recipients are defined, then, the more "spread out" and shallower will be the likely subsidy impact.[890]

Obviously, the trade-distorting effect of a subsidy programme is indeed less in case a particular subsidy amount is spread out over a large number of industries and not concentrated to a single industry. Yet, in first instance, its trade-distorting impact seems to depend on the amount of the subsidy, and not on whether it is generally available.[891] For example, the trade-distorting impact on a particular industry of interest-free loans does, at first sight, not depend on whether many other industries could also benefit from such loans. Nevertheless, scholars have argued that, in simple economic models, an effort to stimulate *all* industrial activity uniformly would in the longer run 'presumably have no real effects at all, and would wash out following some combination of price and exchange rate adjustments'.[892] This idea that trade would not be distorted (i.e., no *international* distortion) as long as the competitive conditions between domestic industries are not affected (i.e., no *domestic* distortion) by subsidization was also expressed by several Contracting Parties during the Uruguay Round to justify the inclusion of the specificity test.[893] At the same time, some of the same scholars acknowledge that a government measure will in practice almost never be so uniform that it does not favour *de facto* one economic sector over another.[894] Hence, such measures will *de facto* affect domestic resource allocation. As Trebilcock and Howse point to, investing in basic infrastructure or education alters a country's comparative advantage (dynamic concept) and

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[890] See World Trade Report 2006, above n 574, at 51, and 198; see also Jackson, above n 588, 296–297.

[891] The general availability just makes it less probable that this amount to a particular industry is significant.

[892] A. O. Sykes, 'The Questionable Case for Subsidies Regulation: A Comparative Perspective', *Working Paper* (April 2009), 41 pp., at 32; Jackson, above n 588, at 297; see also Hufbauer and Erb, above n 542, at 55 (in the context of general tax measures).

[893] For example, according to the EC, 'a distinction should be drawn between general measures designed to stimulate economic activity as a whole and specific measures with identifiable beneficiaries whose competitive position is improved by the intervention'. Likewise, Korea argued that generally available subsidies should be non-countervailable as they 'do not give specific enterprises or industries any particular articular benefit or advantage not available to other enterprises or industries'. See *Submission by the European Community* (MTN.GNG/NG4/W/36, 2 February 1990); *Communication from the Republic of Korea* (MTN.GNG/NG10/W/34, 18 January 1990). Other scholars have also referred to this idea that general subsidies do not distort trade because it does not distort resource allocation among domestic industries. See M. Benitah, *The Law of Subsidies under the GATT/WTO System* (The Hague: Kluwer Law International, 2001), 424 pp., at 258-260; Luengo, above n 771, at 129-130.

[894] Sykes, above n 892, at 32 (in the context of general tax measures); M. Trebilcock and M. Fishbein, 'International Trade: Barriers to Trade', in A. T. Guzman and A. O. Sykes (eds), *Research Handbook in International Economic Law* (Cheltenham: Edward Elgar, 2007), 1-61, at 22; Trebilcock and Howse also doubt that the exchange rate adjustment assumption holds in a world where exchange rates are increasingly determined by capital flows rather than trade flows. M. J. Trebilcock and R. Howse, *The Regulation of International Trade*, 3rd ed (London: Routledge, 2005), 759 pp., at 289.

thus affects domestic resource allocation. The fact that a subsidy will *de facto* always benefit some industries over others implies that an economic rationale for underpinning the 'specificity' element is not watertight.[895] Although the 'specificity' test is inspired on its own CVDs procedure,[896] the US had even reached the conclusion during the Uruguay Round that such test simply had 'no economic justification'.[897,898]

Second, part of the rationale to exclude non-specific subsidies seems to be related to the nature of the government action rather than to the question whether it affects firms' competitive position. In the view of Jackson, the specificity test is not only based on an economic rationale but is also a useful tool to exclude from the scope of the SCM Agreement general activities by all governments (such as police or fire protection, education, roads) 'which really ought not to be brought into a countervailing duty or other international process'.[899] Hence, the provision of non-specific goods/services with public goods characteristics[900] is considered non trade-distorting, not so much because it might not *affect* trade but because it would do so in a *corrective* rather than *distortive* way.[901] In contrast, specific subsidies would give an 'unfair' advantage to the beneficiary.[902]

This is somewhat related to a third potential rationale indicated by Sykes. Specific subsidies might be considered more likely to be motivated by protectionist considerations, and thus by political-economy rather than welfare motivations.[903] Although this argument has some merit, Sykes likewise considers it highly 'speculative' because the degree of specificity of a subsidy programme might very well be based on political rather than economic

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895 See also Mavroidis, Messerlin, and Wauters, above n 729, at 350-351.

896 EC state aid disciplines also only targeted aid favouring 'certain undertakings'. See B. Evtimov, 'Article 2 SCMA', in R. Wolfrum, P-T. Stoll, and M. Koebele (eds), *WTO: Trade Remedies* (Heidelberg: Max Planck Institute for Comparative Public Law and International Law, 2008), 453-470, at 456; Luengo, above n 771, at 330.

897 See *Minutes of the Meeting help on 25 October 1990* (SCM/M/48, 21 December 1990), paras 74, 76.

898 Rubini doubted the accuracy of the economic justification and pointed to practical reasons for such a test in avoiding a review of all programmes and their distorting effects. Rubini, above n 669, 173; see also Jackson, above n 588, at 298.

899 Jackson, above n 588, at 297. See also D. Palmeter, 'Safeguard, Anti-Dumping, and Countervailing Duty Disputes in the Transatlantic Partnership: How to Control "Contingency Protection" More Effectively,' in E-U. Petersmann and M.A. Pollack (eds), *Transatlantic Economic Disputes – the EU, the US, and the WTO* (Oxford: Oxford University Press, 2003), 141-173, at 155; A. O. Sykes, 'International trade: Trade Remedies', in A. T. Guzman and A. O. Sykes (eds), *Research Handbook in International Economic Law* (Cheltenham, Edward Elgar, 2007), 62-112, at 103.

900 Pure public goods are nonrival and nonexclusive in consumption (see above Part I, Chapter 2).

901 As Sykes observes, 'basic expenditures on publication education and road construction, for example, can have profound effects on costs'. Sykes, above n 892, at 31-32.

902 See also Sykes, above n 899, at 103.

903 See also A. O. Sykes, 'Subsidies and Countervailing Measures', in P. F. J., Macrory, A. E. Appleton, and M. G. Plummer (eds), *The World Trade Organization: Legal, Economic and Political Analysis – Volume II* (Heidelberg: Springer Verlag, 2005), 83-107, at 100; see also, Trebilcock and Howse, above n 894, at 289.

considerations, which is illustrated by the widespread subsidization of the agricultural sector.[904]

So far, the case law has not offered much guidance on how it interpreted the rationale for the specificity test. The Panel in *US – Upland Cotton* merely considered that:

> We see merit in the shared view of the parties that the concept of 'specificity' in Article 2 of the *SCM Agreement* serves to acknowledge that some subsidies are broadly available and widely used throughout an economy and are therefore not subject to the Agreement's subsidy disciplines.[905]

3.3.2. Subsidies deemed to be specific

The difficult legal question remains, of course, what is considered 'general' and what degree of specificity is thus targeted under the SCM Agreement. This threshold question should, however, not be passed in case export subsidies and local content subsidies are challenged or countervailed. Both types of subsidies are presumed to be specific.[906] In light of the above-mentioned rationales for the specificity test, such an exception seems understandable, at least for export subsidies.[907,908] To be precise, as the text of Article 2.3 of the SCM Agreement suggests and the Panel in *Indonesia – Autos* confirmed,[909] the irrefutable presumption of specificity is not dependent on whether these subsidies are prohibited but on whether they qualify as export/local content subsidies. Hence, the Panel in *Korea – Commercial Vessels* correctly decided that 'a subsidy that is specific under Article 2.3 (as a result of export contingency) is specific for the purpose of both Part II (prohibited export subsidy) and Part III (actionable subsidy) claims'.[910] Likewise, such subsidies could be deemed to be specific in CVDs procedures.

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[904] Some agricultural subsidies could be deemed non-specific as a legal matter but might very well be motivated by political-economy considerations.

[905] Panel Report, *US – Upland Cotton*, para 7.1143.

[906] Article 2.3 of the SCM Agreement. Panel Report, *US – Upland Cotton*, para 7.1153; Panel Report, *Indonesia – Autos*, para 14.155.

[907] Export subsidies have a more direct effect on trade (see above Part I, Chapter 1) and such subsidies also favour exporting industries at the expense of the other industries from which resources could be channeled. Moreover, export subsidies are hard to consider as legitimate general activities by all governments (see below Part IV, Chapter 2, Section 2.2).

[908] From a conceptual viewpoint, Mavroidis, Messerlin, and Wauters argue that it would have been more accurate to exempt these types of subsidies from the specificity test rather than to stipulate that they are deemed specific. See Mavroidis, Messerlin, and Wauters, above n 729, at 351.

[909] Indonesia benefited from S&D treatment on local content subsidies (by virtue of Article 27.3 of the SCM Agreement) but these subsidies were, nonetheless, deemed to be specific by virtue of Article 2.3 of the SCM Agreement for the actionable subsidy claim. Panel Report, *Indonesia – Autos*, para 14.155.

[910] Panel Report, *Korea – Commercial Vessels*, para 7.514.

3.3.3. Specificity de jure and de facto

Regarding all other types of subsidies, specificity in the meaning of Article 2.1 and 2.2 of the SCM Agreement 'should be clearly substantiated on the basis of positive evidence' if challenged before the WTO-adjudicating bodies or scrutinized in a countervailing duty investigation.[911] 'Positive' evidence means that it is of 'an affirmative, objective and verifiable character, and that it must be credible'.[912] The burden of proof for passing this test rests on the complaining party or CVDs-investigating authority.[913] Clarke and Horlick explain that this was contrary to US CVDs practice since specificity was assumed unless positive evidence to the contrary was provided.[914] Because the subsidizing country is the one having direct access to information for assessing specificity, they further argue that this shift in the burden of proof has the 'potential for creating a significant hurdle to take action'.[915]

Regarding the substance of this specificity test, the chapeau of Article 2.1 of the SCM Agreement somewhat cryptically describes that the subsidy should be specific to 'an enterprise or industry or group of enterprises or industries' (further referred to in the SCM Agreement as 'certain enterprises').[916,917] On this basis, the Panel in *US – Softwood Lumber IV* found that specificity has 'to be determined at the enterprise or industry level, not at the product level' and that 'a single industry may make a broad range of end products'.[918] Similarly, the Panel in *US – Upland Cotton* clarified that 'an industry' covers 'producers of certain products', but recognized that:

> The breadth of this concept of "industry" may depend on several factors in a given case. At some point that is not made precise in the text of the agreement, and which may modulate according to the particular circumstances of a given case, a subsidy would cease to be specific

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911 Article 2.4 of the SCM Agreement.

912 This was elaborated by the Appellate Body in *US – Hot Rolled Steel* (para 192) in the context of anti-dumping and considered applicable by the Panel in *EC – Countervailing Measures on DRAM Chips* under Article 2.4 of the SCM Agreement (para 7.226, footnote 191).

913 The fact that the burden is on the complainant in case subsidization by other WTO Members is challenged before WTO-adjudicating bodies conforms to the general rule as first explained by the Appellate Body in *US – Wool Shirts and Blouses*, at 14. The initial burden of proof rests upon the party, whether complaining or defending, who asserts the affirmative of a particular claim or defence. See also, Clarke and Horlick, above n 587, at 296; Luengo, above n 771, at 140-141.

914 See Clarke and Horlick, above n 587, at 296.

915 See Clarke and Horlick, above n 587, at 296.

916 Article 2.1 of the SCM Agreement. Pursuant to the World Trade Report 2006, this and other provisions in the SCM Agreement referring to producers of subsidized products imply that transfers to consumers 'may not be covered' by the SCM Agreement. World Trade Report 2006, above n 574, at 54.

917 On the vagueness of the delineation between general and specific subsidies, see Trebilcock and Fishbein, above n 894, at 21-22; Sykes, above 902, at 103.

918 For example, a subsidy to the car industry would be specific even though producers make a diversity of products. Panel Report, *US – Softwood Lumber IV*, para 7.121.

> because it is sufficiently broadly available throughout an economy as not to benefit a particular limited group of producers of certain products.[919]

Although the determination should therefore be made on a case-by-case basis, both Panels have endorsed a wide reading of an industry or group of industries. Indeed, subsidies to 'industries producing wood products'[920] and to 'a subset of basic agricultural products'[921] were sufficiently specific to pass the specificity test. Such subsidies to certain enterprises are either *de jure* or *de facto* specific.

First of all, *de jure* specificity occurs if the subsidy is *explicitly* limited to certain enterprises (Article 2.1(b) of the SCM Agreement). According to Article 2.1(b) of the SCM Agreement, specificity would, however, not exist if *objective criteria* or conditions are established governing the eligibility for subsidies. Such eligibility has to be automatic and the criteria should be strictly adhered to and 'clearly spelled out in law, regulation, or other official document, so as to be capable of verification'.[922] These criteria or conditions are considered 'objective' if they are neutral, do not favor certain enterprises over others, and are economic in nature and horizontal in application.[923]

Yet, subsidies that are not limited in law to certain enterprises or that are based on objective criteria can in practice still benefit only certain enterprises. Therefore, the SCM Agreement also encompasses *de facto* specificity (Article 2.1(c) of the SCM Agreement), whereby four factors 'may' be taken into consideration: the use of a subsidy programme by a *limited number* of enterprises, *predominant use* by certain enterprises, the granting of *disproportionately large amounts* of the subsidy to certain enterprises, and *the manner in which discretion has been exercised* by the granting authority in the decision to offer a subsidy.[924] Based on the ordinary meaning ('may') of Article 2.1(c) of the SCM Agreement, the Panel in *US – Softwood Lumber IV* concluded that not all four factors have to be examined

[919] Panel Report, *US – Upland Cotton*, para 7.1142.
[920] This could, for example, encompass the pulp industry, the paper industry, the lumber industry, and the lumber remanufacturing industry. Panel, *US – Softwood Lumber IV*, para 7.121.
[921] The Panel, hereby, stressed that '(t)he fact that some of the subsidies go to farmers who may produce different commodities, or, in theory, may not produce a given commodity does not mean, by some process of reverse reasoning, that the specificity that is apparent from the face of the grant instrument no longer exists'. Likewise, US crop insurance subsidies that were 'generally, available for most crops but (…) not generally available in respect of the entire agricultural sector in all areas' were considered specific. Panel, *US – Upland Cotton*, paras 7.1148, 7.1150.
[922] Article 2.1(b) of the SCM Agreement.
[923] Article 2.1(b), footnote 2 of the SCM Agreement.
[924] Regarding the final factor, footnote 3 of the SCM Agreement stipulates that information on the frequency with which applications for a subsidy are refused or approved and the reasons for such decisions shall be considered.

and evaluated cumulatively to find that a subsidy is *de facto* specific.[925] Moreover, the same Panel held that the text of this provision does not limit specificity to those subsidies *deliberately* limited to certain enterprises: 'Article 2 SCM Agreement is concerned with the distortion that is created by a subsidy which either in law or in fact is not broadly available' and does, therefore, not require an investigation into the intent of the subsidizing country.[926] As a result, a determination by the US CVDs-investigating authority (USDOC) that the Canadian subsidy programme (i.e., stumpage programmes) was used by a limited number of enterprises (i.e., wood product industries) sufficed to find *de facto* specificity. This conclusion was not altered by the fact that it was inherent in the nature of the subsidy in question (i.e., standing timber) that its use was limited to certain enterprises only.[927] In *EC – Countervailing Measures on DRAM Chips*, the disproportionate use by Hynix of the funds made available under the Korea Development Bank Debenture Programme formed the basis for the finding that this programme, as applied, constituted a *de facto* specific subsidy.[928]

In determining the presence of *de facto* specificity, Article 2.1(c) of the SCM Agreement mandates to take into account the extent of economic diversification in the subsidizing country as well as the duration of the subsidy programme. Yet, according to the case law, both elements should not explicitly be addressed by the CVDs-investigating authority if this was not raised by one of the parties during the investigation.[929] The first element comes, in rather vague terms, in to objections of small developing countries that their subsidy programmes would easily meet the standard of *de facto* specificity simply because of the undiversified nature of their economy.

It should be emphasized, as this is often overlooked in the literature and case law, that the opening clause of Article 2.1(c) of the SCM Agreement explicitly stipulates that such *de facto* specificity could be found 'notwithstanding any appearance of non-specificity resulting from the application of the principles laid down in subparagraphs (a) *[de jure specificity]* and (b)

[925] In contrast, all four factors were considered by the EC in its CVDs investigation on Korean DRAM Chips. See *EC – Countervailing Measures on DRAM Chips,* paras 7.226-7.230.

[926] Panel Report, *US – Softwood Lumber IV*, para 7.116. Draft guidelines for the concept of specificity that circulated in the SCM Committee (SCM/W/89, 25 April 1985) had referred to 'de facto *deliberately* granting an advantage to certain enterprises' (emphasis added).

[927] Panel Report, *US – Softwood Lumber IV*, paras 7.121, 7.123. The Panel observed that a subsidy which is limited by the inherent characteristics of the good cannot be based on 'objective criteria' in the sense of footnote 2 to Article 2.1(b) of the SCM Agreement. Panel Report, *US – Softwood Lumber IV*, para 7.116, footnote 179.

[928] More generally, the Panel agreed with the EC's determination of specificity which had found that '(1) the subsidy programme was used by a very limited number of companies, as only six out of an eligible two hundred companies used the programme; (2) that it was predominantly used by the Hyundai group companies among which Hynix190; and (3) that a disproportionate 41 per cent of the total subsidy amount of KRW 2.9 trillion was granted to Hynix'. Panel Report, *EC – Countervailing Measures on DRAM Chips,* paras 7.226-7227.

[929] Panel Report, *EC – Countervailing Measures on DRAM Chips,* para 7.229. The Panel in *US – Softwood Lumber IV* considered it public knowledge that the Canadian economy is diversified and 'is more than just wood products alone'. Panel Report, *US – Softwood Lumber IV*, para 7.124.

[objective criteria]'. As a result, a subsidy programme could still be *de facto* specific even if it is not only *de jure* not limited to certain enterprises but also based on objective criteria as set out above.[930] Hence, the Panel's statement in *US – Upland Cotton* that a programme based on such objective criteria 'would *preclude* an affirmative conclusion of specificity' seems simply premature.[931] Article 2.1(c) of the SCM Agreement clearly provides that such a programme could still be applied in a way that it turns out to be a *de facto* specific subsidy. The case law on *de facto* specificity has illustrated that this would already be the case if, for example, such programme is – by incidence – predominantly used by 'certain enterprises'. Recall in this respect that the term 'certain enterprises' should not be understood narrowly but that this might cover a group of industries each making a broad range of end products.

3.3.4. Regional subsidies

Regarding regional subsidies, Article 2.2 of the SCM Agreement stipulates that:

> A subsidy which is *limited to certain enterprises* located within a designated geographical region within the jurisdiction of the granting authority shall be specific. It is understood that the *setting or change of generally applicable tax rates* by all levels of government entitled to do so shall not be deemed to be a specific subsidy for the purposes of this Agreement.[932]

The first sentence qualifies all sorts of subsidies limited to certain enterprises within a geographical region of the granting authority to be *specific*, whereas the second sentence clarifies that the setting of general tax rates by all competent levels of the government is deemed *non-specific*. Giving substance to both sentences seems not straightforward.

At first sight, the plain wording of the first, general sentence does not seem to have significant legal implications. After all, a similar interpretation would have been reached on the basis of Article 2.1 of the SCM Agreement: because subsidies limited to certain enterprises on the national level are specific, they are *a fortiori* specific if restricted to *certain enterprises* within a region. To grasp its meaning, Article 2.2 of the SCM Agreement should, however, be contrasted with the language in the latest draft version of the SCM Agreement (i.e., Dunkel Draft). The Dunkel Draft stipulated that a 'subsidy which is available to *all enterprises* located within a designated geographical region shall be specific irrespective of the nature of the granting authority'.[933] Clarke and Horlick have revealed that the change to the current version was the result of a compromise between the US and Canada in late 1993. The US hereby agreed upon fewer disciplines on subsidies in return for more trade-restrictive anti-

[930] See Article 2.1(b) and footnote 2 of the SCM Agreement.

[931] The Panel seems to assume that if those objective criteria are effectively adhered to, it would *ipso facto* not be *de facto* specific. See Panel Report, *US – Upland Cotton*, para 7.1143.

[932] Emphasis added.

[933] Article 2.2 of the *Dunkel Draft* (MTN.TNC/W/FA, 20 December 1991) (emphasis added).

dumping rules.[934] To give meaning to this modification, several scholars have therefore suggested that Article 2.2 of the SCM Agreement means, *a contrario*, that subsidies to *all enterprises* located within a designated geographical region are non-specific under the SCM Agreement.[935] Yet, most scholars correctly consider that this *a contrario* reading only holds in case the subsidy is granted by the regional government itself and not when it is offered by the central authority.[936] Several arguments suggest that regional subsidies offered by the central government are indeed 'specific' under the SCM Agreement. First of all, Benitah and Evtimov point to contextual support in the opening clause of Article 2 of the SCM Agreement. This refers to subsidies specific to certain enterprises 'within the jurisdiction of the granting authority'.[937] Next, contextual support might also be found in the (temporal) green light status of subsidies given to disadvantaged regions (Article 8.2(b) of the SCM Agreement). Indeed, this 'green light' status, subject to specific and stringent conditions,[938] would have had no meaning if national subsidies to all industries within such a region would have already qualified as non-specific under Article 2.2 of the SCM Agreement.[939] Lastly, one of the elements underpinning the *US – Upland Cotton* Panel's conclusion that the national US crop insurance was specific related to the fact that it was only available in certain regions and not in the entire US.[940] This limited *a contrario* reading would thus imply that specificity is determined by reference to the level of the granting authority: a subsidy is non-specific if the granting authority (federal or regional) makes a subsidy available to all enterprises in its territory (nationwide or region), whereas such subsidy would be specific if it is limited to certain enterprises within the authority's jurisdiction. The latter implies that a subsidy is specific if the granting authority limits it to a sub-geographical entity.

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[934] See Clarke and Horlick, above n 587, at 695, footnote 82.
[935] See Clarke and Horlick, above n 587, at 695; Benitah, above n 893, at 260; Luengo, above n 771, at 139.
[936] Benitah, above n 893, at 260; Evtimov, above n 896, at 460-461, 467-468. This is also how Adamantopoulos and Pereyra read this provision as incorporated in the EC's Basic Regulation, which sets out the conditions for imposing CVDs. See K. Adamantopoulos and M. J. Pereyra, *EU Anti-Subsidy Law and Practice*, 2nd ed (London: Sweet & Maxwell, 2007), 475 pp., at 164. In contrast, Luengo does not make this distinction. He concluded that the change to the Dunkel draft 'was included in order to allow subsidies granted *by federal* or regional governments to all enterprises or industries located in that territory' (emphasis added). Luengo, above n 771, at 139.
[937] Benitah, above n 893, at 260; Evtimov, above n 896, at 460-461, 467- 468.
[938] One of the conditions was that such a subsidy was 'non-specific (within the meaning of Article 2) within eligible regions'. See also below Part IV, Chapter 2, Section 2.1.1.3.
[939] Under the Dunkel Draft, Article 8.2(b), which was formulated similarly as the current version, was clearly written to give 'green light' status to some regional subsidies that were explicitly deemed specific on the basis of its version of Article 2.2.
[940] 'We note that, even assuming *arguendo* that the text of the granting instrument shows any appearance of non-specificity, record evidence indicates that there are pilotprogrammes for livestock – AGR and "AGR-lite" in certain regions – but that these programmes are not universally available in respect of all livestock within the United States'. Panel Report, *US – Upland Cotton*, para 7.118, footnote 1276. See also above n 921.

The second sentence of Article 2.2 of the SCM Agreement stipulates that the setting of general tax rates by all competent government levels is deemed non-specific. Under the original Dunkel Draft, this second sentence clearly served as an exception to the general rule set out in the first sentence: general tax policies were exempted from the general principle that subsidies available to all enterprises located within a designated geographical region were deemed specific irrespectively of the granting authority. Yet, under the limited *a contrario* reading of the first sentence of Article 2.2 of the SCM Agreement, this second sentence would rather confirm the general rule set out in the first sentence. The determination of specificity is made at the level of the granting authority. The setting of general tax rates by all competent levels of government is deemed non-specific. In contrast, a regional tax reduction given by the central government would be considered specific.[941]

Observe that in earlier negotiations in the Uruguay Round, the EC had firmly opposed that the determination of '*general* availability' relates to the jurisdiction of the granting authority. After all, such an interpretation was not tenable on economic grounds because 'there is no difference, as to their economic effect, between a subsidy granted by a regional or local government to all firms in that region on one hand, and the same subsidy granted to the same firms in the same region but by the central government on the other hand'.[942] Yet, the last-minute compromise between Canada and US might have exactly generated such result. The leeway given to regions to offer generally available subsidies without being captured under the SCM Agreement (i.e., neither challengeable, nor countervailable) is considered legitimate because it respects the federal structure of some WTO Members.

[941] See also Evtimov, above n 896, at 468.
[942] *Submission by the European Community* (MTN.GNG/NG4/W/36, 2 February 1990), at 6.

4. DISCIPLINES ON SUBSIDIES

Evidently but importantly, the SCM Agreement does not condemn all specific subsidies covered under Articles 1 and 2 of the SCM Agreement. The Appellate Body, recognizing the broad definition of the subsidy-concept, stressed that:

> The granting of a subsidy is not, in and of itself, prohibited under the SCM Agreement. Nor does granting a 'subsidy', without more, constitute an inconsistency with that Agreement. The universe of subsidies is vast. Not all subsidies are inconsistent with the SCM Agreement.[943]

Articles 1 and 2 merely define the concepts of subsidy and specificity and do not in themselves impose any obligation with respect to such 'specific subsidies'. These articles serve as a threshold for the application of the disciplines prescribed by Parts II, III, IV, and V of the SCM Agreement.[944] The SCM Agreement aims at targeting those subsidies that are trade-distorting. To this end, the agreement as originally implemented when the WTO Agreement came into effect grouped subsidies in three categories, each imposing different disciplines.[945] This so-called 'traffic light approach' proved pivotal to find a compromise between the harsh stance of the US and the looser stance of other countries on disciplining subsidies. On the one end, two types of subsidies were principally *prohibited* in and of themselves (red light) because of their direct trade-distorting effect, namely export subsidies and local content subsidies (Part II of the SCM Agreement). On the other end, three types of subsidies, namely, for research activities, for disadvantaged regions, and for the adaptation to environmental requirements, were deemed *non-actionable* (green light). These were in principle allowed under the SCM Agreement (Part IV of the SCM Agreement). All other subsidies were *actionable subsidies* (rest category, amber light), meaning that they could be challenged or countervailed if they caused adverse effects (Part III of the SCM Agreement).
However, the category of green light subsidies already expired at the end of 1999.[946] Since then, just two categories are in place: those subsidies that are prohibited *as such* (red light) and all others that can be challenged if they cause adverse effects to the interests of other WTO Members (amber light). Specific subsidies that were previously granted green light status are thus currently actionable if they cause adverse effects. The category of prohibited

[943] Appellate Body Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para 47.
[944] See also Appellate Body Report, *US – FSC (Article 21.5 – EC)*, paras 85–87. Given that they merely define the terms 'subsidy' and 'specificity', Articles 1 and 2 of the SCM Agreement cannot be considered to be 'violated', as the Panel in *US – Export Restraints* seemed to suggest. See Panel Report, *US – Export Restraints*, para 9.1. Likewise, as elaborated above (see above n 869, 871, 872), a CVDs procedure can, in my opinion, not be merely inconsistent with Article 1 of the SCM Agreement, even though some panels have reached this conclusion.
[945] The origins of the traffic light approach date back to proposals made by the US during the Tokyo Round. See Hufbauer and Erb, above n 542, at 22; Croome, above n 579, at 62.
[946] Article 31 of the SCM Agreement.

subsidies circumvents the difficult proof of adverse effects[947] and more powerful tools are provided to challenge such prohibited subsidies. We start with an analysis of those subsidies that are captured under this prohibition set out under Part II of the SCM Agreement.

4.1. PROHIBITED SUBSIDIES

Article 3 of the SCM Agreement targets two types of subsidies:

> (a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I;
> (b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.

These export subsidies (a) and local content subsidies (b) are prohibited and may thus not be granted nor maintained[948] because they are considered trade-distorting by their very nature.[949] Expansion of the red light category beyond the Illustrative List of Export Subsidies of the Subsidies Code was one of the most contentious issues during the Uruguay Round, with the US as its main proponent.[950] In the Doha negotiations, the US and the EC also proposed an expansion of the red light subsidies beyond these two types of subsidies. Whereas the US mainly aimed to bring the so-called 'dark amber' types of domestic subsidies under the category of export subsidies, the EC primarily aimed at expanding the scope of local content subsidies.[951]

Before examining the substance of both types of prohibited subsidies, we look at the requirement of 'contingency', which is a cross-cutting issue. To qualify as export subsidy, it has to be shown that a subsidy is 'contingent' upon exportation. To qualify as local content subsidy, it has to be shown that a subsidy is 'contingent' upon the use of domestic over imported goods.

[947] As mentioned above, prohibited subsidies are also deemed to be specific (Article 2.3 of the SCM Agreement).
[948] Article 3.2 of the SCM Agreement.
[949] Stewart, above n 579, at 886.
[950] Recall that the US aimed to expand the Illustrative List of prohibited subsidies to primary products, as well as to domestic subsidies having a significant effect on trade or competitiveness. The trade effect had to be determined on the basis of objective criteria such as the amount of the subsidy. See *Communication from the United States* (MTN.GNG/NG10/W/20, June 15, 1988), at 3-4. See Stewart, above n 579, at 886–890.
[951] For example, the US proposed to move all but one (i.e., Article 6.1(a)) of the subsidies spelled out in Article 6 of the SCM Agreement to the category of prohibited subsidies. *Communication from the United States, Subsidies Disciplines Requiring Clarification and Improvement* (TN/RL/W/78, 19 March 2003); *Paper from the United States, Expanding the Prohibited "red light" Subsidy Category* (TN/RL/GEN/94, 16 January 2006); *Proposal from the United States, Expanding the Prohibited "red light" Subsidy Category, Draft Text* (TN/RL/GEN/146, 5 June 2007); *Submission of the European Communities, Subsidies* (TN/RL/GEN/135, 24 April 2006).

The term 'contingent' in these definitions should be understood as 'conditional' or 'depending for its existence on something else'.[952] This conditionality could operate *in law* but also *in fact,* which prevents governments from circumventing the prohibition by linking subsidies to export performance or local content without prescribing it explicitly in their laws.[953]

As to export subsidies (Article 3(1)(a)), *de jure* export conditionality should be 'demonstrated on the basis of the words of the relevant legislation, regulation or other legal instrument'.[954] *De facto* export conditionality is explicitly prescribed in the SCM Agreement, which even indicates how this should be determined. The complaining party should demonstrate three different substantive elements[955]: (i) the granting of a subsidy[956] is (ii) in fact tied to[957] (iii) actual or anticipated exportation or export earnings.[958] The mere fact that a subsidy is granted to export-oriented industries is considered insufficient in itself.[959]

As far as local content subsidies (Article 3(1)(b)) are concerned, the type of conditionality is not explicitly prescribed, but case law indicates that it likewise covers both *de jure* and *de facto* contingency. Indeed, the Appellate Body in *Canada – Autos* disagreed with the Panel's decision that limited the scope to conditionality in law.[960] Moreover, the Appellate Body contemplated the legal standard of *de jure* contingency similar to that under Article 3(1)(a).[961]

The question arises as to what degree of conditionality is required by the term 'contingent upon'.[962] What is sure is that, as indicated, the mere fact that a subsidy is granted to export-oriented industries does not reach the required degree of conditionality.[963] Furthermore, the definitions indicate that a subsidy could qualify as an export subsidy (or local content subsidy) if export performance (or local content) is one among other conditions for receiving the subsidy. In other words, export performance (or local content) does not have to be a

[952] Appellate Body Report, *Canada – Aircraft*, para 166.
[953] Appellate Body Report, *Canada – Aircraft*, para 167.
[954] Appellate Body Report, *Canada – Aircraft*, para 167. See also Appellate Body Report, *Canada – Autos*, para 100.
[955] See Article 3.1(a), footnote 4 of the SCM Agreement.
[956] Appellate Body Report, *Canada – Aircraft*, para 170.
[957] This second element is 'at the very heart of the legal standard in footnote 4'. 'Tied to' refers to 'limit or restrict as to (…) conditions'. It requires a demonstration of a relationship of conditionality or dependence. Therefore, 'tied to' is similar to 'contingent upon'. See Appellate Body Report, *Canada – Aircraft*, para 171.
[958] Appellate Body Report, *Canada – Aircraft*, para 172.
[959] Article 3.1(a), footnote 4 of the SCM Agreement.
[960] Appellate Body Report, *Canada – Autos*, paras 135-143. The primary reason of the Appellate Body seemed to be the circumvention argument (see para 142).
[961] Appellate Body Report, *Canada – Autos*, para 123. The Appellate Body did not decide upon *de facto* contingency because of the incomplete analysis of the Panel.
[962] Article 3.1(a) and (b) of the SCM Agreement.
[963] Article 3.1(a), footnote 4, second sentence of the SCM Agreement. Export orientation can be a relevant fact to demonstrate that the subsidy is 'tied to' exportation or export earnings, provided that it is one of several other facts which are considered. See Appellate Body Report, *Canada – Aircraft*, para 173.

sufficient condition for receiving the subsidy: other conditions might in addition be required.[964] In contrast, one could ask oneself whether export performance (or local content) must constitute a *necessary* condition for receiving the subsidy.

Whereas the text of the SCM Agreement does not provide a clear answer, the Panel in *Canada – Aircraft* considered export performance a necessary condition because it applied a 'but for' test. The essential question was whether Canada would have granted the subsidy but for the export performance.[965] Although the Appellate Body agreed with the Panel's 'overall approach to *de facto* export contingency', it dismissed the 'but for' test because this test did not fit into the actual language of the Agreement.[966] The Appellate Body did not indicate, however, what degree of conditionality it exactly had in mind. It only clarified that 'it does *not* suffice to demonstrate solely that a government granting a subsidy *anticipated* that exports would result'.[967]

The measure at issue in *Canada – Autos* illustrates that the question of necessary conditionality of the measure as a whole might not be decisive in all cases. First, concerning export contingency, a manufacturer could receive a certain amount of import duty exemptions (subsidies) even if he did not export. Yet, 'the more motor vehicles a manufacturer exports (*export performance*), the more motor vehicles that manufacturer is entitled to import duty-free (*subsidy*)'.[968] On this basis, the Appellate Body concluded that the measure was contingent upon export.[969] Referring to footnote 4 of the SCM Agreement, the Appellate

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[964] See Article 3.1(a) and (b): 'whether solely or as one of several other conditions'. See, for example, Appellate Body Report, *US – FSC (Article 21.5 – EC)*, para 111 *in fine*.

[965] Panel Report, *Canada – Aircraft*, paras 9.332 and 9.340.

[966] Appellate Body Report, *Canada – Aircraft*, para 171, footnote 102.

[967] Appellate Body Report, *Canada – Aircraft*, para 171 (emphasis in the original).

[968] Appellate Body Report, *Canada – Autos*, para 106 (emphasis added). Two situations were distinguished by the Panel and Appellate Body. The first situation is where the production-to-sales ratio requirements are 100:100 or higher, which was a condition to be eligible for the import duty exemption. It is in essence a ratio of the net sales value of the vehicles *produced in Canada* to the net sales value of all vehicles of that class *sold* for consumption *in Canada*. So, as the Panel indicated correctly, to meet such standard, for every unit a manufacturer imports duty-free, it would have to export an equivalent unit value. Thus, exportation is, in this first situation, clearly a necessary condition for receiving the subsidy (import duty exemption). Yet, the stringent production-to-sales ratio requirements were relaxed to some extent under situation 2. For example, manufacturers with a ratio of 95:100 that do not export are nevertheless entitled to import duty-free vehicles with a sales value of 5. Up to this amount, the Panel and the Appellate Body reasoned that the import duty exemption is not contingent upon export performance. For any amount above this duty-free allowance, the value of vehicles imported duty-free is strictly limited to the value of vehicles exported and, as a consequence, for that amount there is a clear relationship of contingency pursuant to the Panel and Appellate Body.

[969] Is export contingency a necessary condition to receive the subsidy? This question is indeed not fine-tuned enough to be answered for the measure as a whole. Up to a certain amount of subsidies, exportation is not a necessary condition. If a manufacturer aims to receive more duty-free (subsidized) imports, it should export the same value, and exportation becomes thus a necessary condition. The level of the amount upon which exportation becomes necessary is essential to decide whether the measure as a whole can be considered as contingent upon export. This was, however, not considered relevant by the Appellate Body.

Body thus required a 'tie'[970] (i.e., a positive correlation) between the export performance and the subsidy without clarifying the required strength of the tie (i.e., the degree of correlation).[971] Second, concerning local content contingency, the import duty exemption was contingent upon certain Canadian Value Added (CVA) requirements. The definition of CVA included parts and materials of Canadian origin (i.e., local content) among other elements such as labor costs and manufacturing overheads. The Panel considered the subsidy as not contingent upon local content because a manufacturer might be able to satisfy the CVA requirement without using any domestic good whatsoever. However, the Appellate Body rejected the Panel's conclusion because it had overlooked the level of CVA requirements. As an example, the Appellate Body indicated that 'if the level of the CVA requirements is very high, we can see that the use of domestic goods may well be *a necessity* and thus be, in practice, required as *a condition* for eligibility for the import duty exemption'.[972] The Appellate Body thus also seems to refer to 'necessary conditionality', but this had to be determined in relation to the level of CVA requirements.[973]

In *US – FSC (Article 21.5 – EC)*, the US contended that export contingency should be understood as a necessary condition and therefore argued that the ETI measure was export-neutral. After all, the ETI measure granted a tax exemption (subsidy) when goods are *sold* for use abroad and was thus available with respect to goods *not* produced in the US.[974] Yet, the Panel and the Appellate Body reached a different conclusion by distinguishing two situations. First, when goods are *produced domestically* and sold for use abroad, exporting is obviously a necessary condition for receiving the tax exemption and the tax benefit is thus contingent

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[970] Appellate Body Report, *Canada – Autos*, paras 107–108. See also Panel Report, *Australia – Automotive Leather II*, paras 9.55-9.71.

[971] As indicated, the level of the amount upon which exportation becomes necessary might have to be taken into consideration (see above n 969). This might be illustrated by a far-fetched example: What if the Canadian subsidy program allowed that even manufacturers with a production sales ratio of 10:100 that do not export were still entitled to import duty-free vehicles? This implies that they could import 90 per cent of (the value of) their sales duty-free (subsidy) without any exportation requirement. Is this subsidy really contingent upon exportation? If the test is 'whether they could import more if they exported more', the answer is nevertheless affirmative.

[972] Appellate Body Report, *Canada – Autos*, para 130 (first emphasis added).

[973] After all, the Appellate Body continued:

> 'By contrast, if the level of the CVA requirements is very low, it would be much easier to satisfy those requirements *without* actually using domestic goods; for example, where the CVA requirements are set at 40 per cent, it might be possible to satisfy that level simply with the aggregate of other elements of Canadian value added, in particular, labor costs. The multiplicity of *possibilities* for compliance with the CVA requirements, when these requirements are set at low levels, may, depending on the specific level applicable to a particular manufacturer, make the use of domestic goods only one *possible* means (means which might not, in fact, be utilized) of satisfying the CVA requirements'.

Appellate Body Report, *Canada – Autos*, para 130 (emphasis in the original). The emphasized wording 'only one *possible* mean' indicates that this example is not considered as a condition.

[974] Appellate Body Report, *US – FSC (Article 21.5 – EC)*, para 110.

upon export.[975] The Panel and Appellate Body did not decide upon the second situation, whereby goods are *produced abroad* and sold for use abroad, which does clearly not involve any exportation from the US.[976] Importantly, the fact that the subsidies granted in the second situation might not be export contingent 'does not dissolve the export contingency' arising in the first situation[977] because it concerns two different factual situations.[978] The crux of the argument seems that both situations are different because they are mutually exclusive. For property produced in the US, exportation is the only option to benefit from the tax exemption. Whereas export contingency is thus not a necessary condition for receiving the subsidy in light of the ETI measure as a whole, the ETI measure with respect to the first situation is considered export contingent.[979]

This case law has illustrated that the 'contingency'-test is rather complex and that this determination will have to be decided upon on a case-by-case basis. In this exercise, the text of the SCM Agreement does not provide much guidance to the WTO-adjudicating bodies on where they have to draw the line.[980] Overall, the case law does not seem to require a very stringent 'tie' between the subsidy and export (local content) performance to qualify a subsidy as an export subsidy (local content subsidy).

[975] Appellate Body Report, *US – FSC (Article 21.5 – EC)*, paras 116-118.

[976] Appellate Body Report, *US – FSC (Article 21.5 – EC)*, paras 109 and 120.

[977] 'Conversely, the export contingency arising in these circumstances (*situation 1)* has no bearing on whether there is an export contingent subsidy in the second set of circumstances' (emphasis added). See Appellate Body Report, *US – FSC (Article 21.5 – EC)*, para 119.

[978] See Appellate Body Report, *US – FSC (Article 21.5 – EC)*, paras 113-115. The Appellate Body indicated that the distinctiveness is confirmed by the text of the ETI measure. Moreover, the two situations 'must be different since the very same property cannot be produced both within and outside the United States'. One and the same natural or legal person may, of course, benefit under both situations (see para 119).

[979] Because exportation is a necessary condition in this situation and another sufficient condition involves a different situation. See also, Appellate Body Report, *US – Upland Cotton*, paras 556-584.

[980] Raising concerns about different interpretations by the WTO-adjudicating bodies, Australia and Brazil have introduced proposals in the Negotiation Group on Rules to amend the text of the SCM Agreement on this issue (*Communication from Australia, Prohibited Export Subsidies* (TN/RL/GEN/34, March 23, 2005); *Paper from Brazil, De Facto Export Contingency* (TN/RL/GEN/88, November 18, 2005)). In response to the Panel Report in *Australia – Automotive Leather II* (see above n 970), Australia raised the concern that the current rules would disadvantage Members with small domestic markets because 'WTO case law has appeared to place a greater weight on the export propensity of a product in the range of factors which are examined to determine export contingency. (…) A subsidy provided to a product by a WTO Member with a large domestic market for that product may be actionable but carry little if no risk of being found to be export contingent. The same subsidy provided to a product by a WTO Member with a relatively small domestic market may represent a very high risk of being contingent on export performance given a much higher export orientation'. See *Communication from Australia, Prohibited Export Subsidies* (TN/RL/GEN/22, October 19, 2004). See also T. Chen, P. Wu, and J. Juo, 'Reconsidering Prohibited Export Subsidies in Doha Negotiations,' in M. Matsushita, D. Ahn, and T. Chen (eds), *The WTO Trade Remedy System: East Asian Perspectives* (London, Cameron May, 2007), 337–355.

4.1.1. Export subsidies

Article 3.1 of the SCM Agreement reads in the relevant part:

> Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:
> (a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I (…).

Notice, first of all, that the opening part of Article 3.1 installs an exception on agricultural export subsidies that are in conformity with the Agreement on Agriculture. In Chapter 6, it will be examined whether such export subsidies are still exempted from this prohibition set out in the SCM Agreement.[981] Turning to non-agricultural subsidies, these are prohibited if 'contingent (…) upon export performance, including those illustrated in (the Illustrative List)'.[982]

Two undisputed conclusions can be derived from this text of Article 3.1(a) of the SCM Agreement on its relationship with the Illustrative List (Annex I).[983] First, the Illustrative List, by definition, only lists 'examples – illustrations'[984] of export subsidies. Some subsidies thus fall outside the Illustrative List's scope but are covered under the export subsidy definition stipulated in Article 1 *juncto* 3.1(a) of the SCM Agreement.[985] Second, a subsidy that falls within the scope of the Illustrative List is deemed to be a prohibited export subsidy.[986] Consequently, the complaining party does not first have to demonstrate that these subsidies are contingent upon export performance under Article 3.1(a) of the SCM Agreement. Complainants could by-pass the export contingency demonstration spelled out in the previous section and directly base their claim on one of the items of the Illustrative List.
Yet, could complainants use the Illustrative List not only to jump the 'export contingency' test of Article 3.1(a) SCM Agreement but also to by-pass the 'subsidy' test under Article 1 of the SCM Agreement? Recall that Article 3.1 of the SCM Agreement explicitly states that 'the following subsidies, *within the meaning of Article 1*, shall be prohibited: (a) subsidies

[981] See below Part II, Chapter 6, Section 6.2.3.1.
[982] Wording between brackets added. As will be explained below (Part, Chapter 6, Section 6.2.3.1), the same prohibition applies to agricultural export subsidies *not* in conformity with the Agreement on Agriculture.
[983] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para 6.29-6.31.
[984] Appellate Body Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para 61.
[985] This also follows from the wording 'including' (Article 3.1(a) of the SCM Agreement). Some countries had suggested during the Uruguay Round to convert it into a definitive and exhaustive list. Yet, this was opposed by other countries such as the US and EC. See Stewart, above n 579, at 888.
[986] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, paras 6.30–6.31. This was implicitly endorsed by the Appellate Body Report. Appellate Body Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para 61.

contingent, (…), upon export performance, including those illustrated in Annex I'.[987] Above, the subsidy definition of Article 1 also leaves no doubt that it applies 'for the purpose of this Agreement', which implies, in the words of the Appellate Body, that this 'applies wherever the word "subsidy" occurs throughout the *SCM Agreement* and conditions the application of the provisions of that Agreement regarding *prohibited* subsidies in Part II (…)'.[988] This might suggest that only subsidies within the meaning of Article 1 of the SCM Agreement could be prohibited under the SCM Agreement and that complainants should, as a result, not be allowed to jump directly to the Illustrative List.[989] On the other hand, this reading would firmly reduce the relevance of the Illustrative List. Indeed, the Illustrative List, predating the subsidy definition, provides more guidance on what GATT Contracting Parties considered a 'subsidy' than on the 'export contingency' element. By including the Illustrative List in the SCM Agreement, WTO Members apparently agreed that this list should still be relevant.[990] This might also explain why the panels in *Brazil – Aircraft (Article 21.5 – Canada)* and *Korea – Commercial Vessels* have explicitly stated that complainants could very well directly rely on the Illustrative List without the need for demonstrating the subsidy element.[991] Similarly, panels and the Appellate Body (as well as all parties) in all *US – Upland Cotton* proceedings agreed that measures that fall under item (j) of the Illustrative List are *per se* export subsidies without the need for a separate analysis under Articles 1 and 3 of the SCM Agreement.[992,993] According to the Panel in *US – Upland Cotton,* Article 3.1(a) of the SCM Agreement sets out 'a prohibition on subsidies contingent upon export performance, "including those illustrated in Annex I"'.[994]

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[987] Emphasis added.

[988] Appellate Body Report, *US – FSC*, para 93. According to the Panel in *US – Softwood Lumber IV* (para 7.104, footnotes deleted):

> 'The chapeau of Article 1.1 SCM Agreement explicitly states that the concept and definition of what constitutes a "subsidy", as set forth in that Article, applies to the entire Agreement. Thus, it is clear that this most basic definition of the Agreement informs every other reference to "subsidy" in the Agreement'.

[989] Unless, of course, all items in the Illustrative List are, by definition, beneficial financial contributions in the meaning of Article 1 of the SCM Agreement (or income or price support).

[990] The cost-to-government approach under the Illustrative List (advocated by the EC) is generally considered more flexible than the benefit-to-recipient approach elaborated under Article 1 of the SCM Agreement.

[991] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, paras 6.43-6.44. See also Panel Report, *Korea – Commercial Vessels*, para 7.204. The Panel in *Korea – Commercial Vessels* observed that this 'perhaps reflects the historical context of the *Illustrative List*, in the sense that it was first drafted before the definition of "subsidy" set forth in the *SCM Agreement* was introduced' (footnote 126).

[992] Panel Report, *US – Upland Cotton*, paras 7.802-7.803, 7.946-7.948 and 8.1(d)(i); Appellate Body Report , *US – Upland Cotton*, paras 666, 720-733 and 763(e)(iv); Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 14.52; Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, paras 322-323.

[993] See also Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, para 5.154.

[994] Panel Report, *US – Upland Cotton*, footnote 1125. This should be contrasted with the Panel's view on local content subsidies where it found support in the sentence 'within the meaning of Article 1' (which is part of the introducing sentence of Article 3.1 and not of Article 3.1(b) as the Panel seems to

In sum, complainants can make use of two different tracks to demonstrate that a subsidy is a prohibited export subsidy under the SCM Agreement: on the basis of Article 1 *juncto* 3 of the SCM Agreement or by reference to the Illustrative List if the measure is listed under one of its items. Because the subsidy definition under both approaches might differ, the question on the correct implementation might arise: does implementation differ depending on whether the existence of an export subsidy is demonstrated on the basis of Article 1 *juncto* 3 of the SCM Agreement or the Illustrative List? Part III will explain in detail how this question was solved in the case *US – Upland Cotton*.[995]

Both tracks to meet the export subsidy definition are further explored. Importantly, as will be explained subsequently, the Illustrative List might in some instances be used *a contrario* as well, namely to demonstrate that some forms of export subsidies (in the meaning of Article 1 *juncto* 3 of the SCM Agreement or the Illustrative List) are *not* prohibited under the SCM Agreement.

4.1.1.1. Export subsidies in the meaning of Article 1 juncto 3 of the SCM Agreement

Under this first track, all elements to demonstrate the existence of an 'export subsidy' have been introduced above. First, the complainant should demonstrate the presence of a 'subsidy' under Article 1 of the SCM Agreement: a financial contribution by the government (or income/price support) confers a benefit. In contrast to some items of the Illustrative List, this subsidy definition applies a benefit-to-recipient standard and not a cost-to-government standard. The relevant question under Article 1 of the SCM Agreement is not whether the government incurred a cost when making the financial contribution, but whether this financial contribution was beneficial to the recipient. Second, the complainant should demonstrate that such a subsidy is *de jure* or *de facto* 'contingent' upon exportation along the lines explained in the previous section. The specificity test should not be passed because 'export subsidies' are deemed to be specific.[996] These export subsidies are prohibited by virtue of Article 3.1 and 3.2 of the SCM Agreement unless an exception in the Illustrative List could be invoked (see below Section 4.1.1.3).

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present it) for its interpretation that, in order to be a local content subsidy, it must be a subsidy in the meaning of Article 1 of the SCM Agreement. Panel Report, *US – Upland Cotton*, para 7.1076.

[995] See below Part III, Chapter 4, Section 4.3.3.2; Part III, Chapter 5, Section 5.1.1.2.2.

[996] Article 2.3 of the SCM Agreement.

4.1.1.2. Export subsidies in the meaning of one of the items of the Illustrative List

Alternatively, measures are prohibited 'export subsidies' if they are covered by one of the items of the Illustrative List, which is basically the same as the list included in the Subsidies Code.[997]

Three listed examples of export subsidies do not need much explanation. They either do not add anything to the Article 1 *juncto* 3 export subsidy definition or are insignificant nowadays. An example of the first category is the opening item of the list, which refers to the provision by governments of 'direct subsidies' to a firm or an industry contingent upon export performance [item (a)]. Likewise, the last item of the list, which was included as a residual category in the Subsidies Code, also seems redundant because it refers to any other charge on the public account constituting an export subsidy in the sense of Article XVI of the GATT [item (l)].[998] Lastly, currency retention schemes or any similar practice that involves a bonus on exports are likewise prohibited [item (b)].[999] Such multiple currency practices, for which IMF approval is required, were prevalent when the list was originally drafted in the 1950s but are almost non-existent today.[1000]

The remaining items of the Illustrative List could be grouped into three categories, each relating to one of the three types of financial contributions singled out under Article 1 of the SCM Agreement. To be clear, this categorization is only made for analytical purposes and does not imply that those items would *ipso facto* be covered under Article 1 of the SCM Agreement.

[997] As explained, the list of the Subsidies Code was based on the 1960 Declaration (see above Part II, Chapter 1, Section 1.2).

[998] Luengo reveals that this item was included in the Subsidies Code because of the different interpretation of 'subsidy' between the US (focusing on benefit) and the EC (focusing on the cost to government or charge on the public account). Luengo, above n 771, 151.

[999] Siegel indicated that a currency retention scheme 'usually involves allowing certain exporters to retain a portion of their foreign exchange earnings notwithstanding a general rule for residents to surrender receipts of foreign exchange to local banks, or the central bank, in exchange for local currency'. As Dam explained, such currency retention scheme could form an important incentive to export because, depending upon the details of the scheme, such foreign exchange earnings could either be sold by exporters on the free market, where, because of the scarcity of foreign exchange, they could charge a higher price than under the official exchange rate, or they could be used to import goods that were otherwise unavailable under the applicable exchange control regulation. Such currency retention schemes involving a bonus upon exports are thus prohibited export subsidies. D. E. Siegel, 'Legal Aspects of the IMF/WTO Relationship: The Fund's Articles of Agreement and the WTO Agreements', 96:3 *American Journal of International Law* (2002), 561-599, at 596; K. W. Dam, *The GATT – Law and International Economic Organization* (Chicago: The University of Chicago Press, 1970), 480 pp., at 137-138.

[1000] The relevance of this item was already questioned during the 1970s. See *Note by the Secretariat on the Meeting of June 1972* (Spec(72)61, 12 July 1972), at 2.

4.1.1.2.1. The provision of goods or services favourable to exporters

Two items of the Illustrative List relate to the provision of goods or services favourable to exporters. First, the government is not allowed to subsidize exports by providing or mandating internal transport and freight charges on export shipments on terms more favorable than for domestic shipments [item (c)].[1001,1002] The second type is broader and requires some further discussion [item (d)]. In essence, item (d) prohibits governments to provide products (or services) on more favourable terms if these are used in export production. In particular, the panels in *Canada – Dairy* distinguished three elements that should be present to find a violation of item (d): '(1) the provision of products for use in export production on terms more favourable than for provision of like products for use in domestic production; (2) by governments either directly or indirectly through government mandated schemes; and (3) on terms more favourable than those commercially available on world markets'.[1003]

Item (d) thus explicitly covers the indirect provision of goods/services through government mandated schemes. This also covers situations whereby the government delegates authority to its agency, 'which, in turn, set up a "government-mandated" scheme'.[1004] Yet, one might wonder whether the required government nexus under item (d) is looser than under the entrustment/direction standard stipulated in Article 1.1(a)(iv) of the SCM Agreement.[1005] In *Canada – Dairy (Article 21.5 – New Zealand and US II)*, this seemed to be the parties' assumption since the complainants based their argumentation on item (d) of the Illustrative List, whereas Canada argued that the scope of item (d) should be interpreted in light of Article 1.1(a)(iv) of the SCM Agreement. The Panel, however, followed the complainants' view because the Illustrative List contains *per se* violations. To interpret item (d) of the Illustrative List, the Panel therefore disregarded the entrustment/direction standard of Article 1.1(a)(iv) of the SCM Agreement.[1006] The Panel concluded that 'the provision of goods is made or

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[1001] See Dam, above n 999, at 140. Because the exporter receives a service in return for its contribution, such a 'charge' should not be considered a 'tax' and item (c) is therefore not discussed as an example of revenue foregone. The concept of 'tax' is not defined in any of the WTO Agreements. For a definition of the terms 'tax' and 'charge' in the context of the OECD, see *Note by the Chairman, Definition of Taxes* (DAFFE/MAI/EG2(96)3, 16 April 1996).

[1002] The comparison is thus made between charges for export shipments and those for domestic shipments. As the Panel in *Brazil – Aircraft* underscored, this is 'irrespective of whether those charges are higher, lower or equal to the charges paid with respect to the shipments of competing products from other Members'. Panel Report, *Brazil – Aircraft*, para 7.25.

[1003] Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, para 5.157. Panel Report, *Canada – Dairy*, paras 7.128-7.131.

[1004] Panel Report, *Canada – Dairy*, para 7.130.

[1005] Regarding the scope of Article 1.1(a)(iv) of the SCM Agreement, see above Part II, Chapter 3, Section 3.2.2.

[1006] The Panel relied upon item (d) of the Illustrative List to interpret the meaning of 'export subsidy' under Article 10.1 of the Agreement on Agriculture. The Panel had previously found a violation of Article 9.1(c) of the Agreement on Agriculture but also scrutinized Article 10.1 in the alternative. Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, paras 5.153, 5.154, 5.159, 5.160.

mandated by government for export as a result of the prohibition on diversion of CEM back into the domestic regulated market and the exemption which gives processors for export access to the lower CEM prices'.[1007] In response to previous rulings, Canada had attempted to remove government action from the export transactions by introducing a new category of milk for export processing, Commercial Export Milk (CEM). This CEM was exempted from the pricing regulations applicable to other types of milk.[1008] Price and volume of CEM were negotiated directly between processor and producer and the diversion of CEM onto the domestic market was prohibited. Yet, Canada's argument based on Article 1.1(a)(1)(iv) of the SCM Agreement that 'there is no provision of products through a government mandated scheme because the government does not command or direct producers to produce CEM' was thus simply considered irrelevant. Although the Appellate Body did not go into the interpretation of item (d),[1009] it seemed to qualify the Panel's wide interpretation of this item of the Illustrative List. After all, the Appellate Body explicitly contrasted the loose government nexus under the listed types of agricultural export subsidies (i.e., Article 9.1(c) of the Agreement on Agriculture) with both Article 1.1(a)(1)(iv) of the SCM Agreement and item (d) of the Illustrative List.[1010] Drawing this comparison, the Appellate Body observed that, even though Article 9.1(c) of the Agreement on Agriculture 'certainly covers situations where government *mandates* or *directs* that payments be made, it also covers other situations where no such *compulsion* is involved'.[1011] *A contrario*, some kind of *compulsion* of a third party seems required not only under Article 1.1(a)(1)(iv) of the SCM Agreement but also under item (d) of the Illustrative List.[1012] Whereas the Appellate Body did not equate the required government nexus under Article 1.1(a)(1)(iv) and item (d) of the Illustrative List, its

[1007] Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, para 5.160. The Panel also found support in Article 9.1(c) of the Agreement on Agriculture.
[1008] The operation of the system challenged before the original panel is summarized in Panel Report, *US – Export Restraints*, para 8.43.
[1009] Because the Appellate Body agreed with the Panel that the Canadian measure was an export subsidy under Article 9.1(c) of the Agreement on Agriculture (listed type of export subsidy), it reasoned that such a subsidy could not qualify as a non-listed type of export subsidy (Article 10.1 of the Agreement on Agriculture). Therefore, the Appellate Body considered the Panel's reasoning under Article 10.1 of the Agreement on Agriculture, whereby the Panel relied on item (d) for contextual support, as moot and of no legal effect. See Appellate Body, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, para 158.
[1010] The Appellate Body also referred to other items of the Illustrative List.
[1011] Appellate Body, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, para 128 (emphasis added).
[1012] Arguably, the Canadian scheme was such a situation in which no compulsion was involved. Hence, it would seem to fall outside the scope of item (d) of the Illustrative List and Article 1.1(a)(1)(iv) of the SCM Agreement. Yet, the required nexus between the government and the payment was sufficient to bring it within the scope of Article 9.1(c) of the Agreement on Agriculture (see above n 1009; below Part II, Chapter 6, Section 6.2.1.2.1.1).

conclusion implies that both have at least in common that they necessitate some form of compulsion in case a subsidy is provided through a third party.[1013]

4.1.1.2.2. Border tax adjustments and duty drawback systems

Five examples of export subsidies in the Illustrative List deal with fiscal incentives (items e, f, g, h, i) in which the government foregoes revenue otherwise due by exporters. As the following two sections explain, these items address under what conditions taxes as well as import duties could be rebated upon exportation.

4.1.1.2.2.1. Border tax adjustments

Border tax adjustments encompass the imposition of a tax on imported products equal to a corresponding tax on domestic products (import side) and the rebate of such a tax on exported products (export side). Hence, such tax adjustments put into effect the destination principle, in which products are only taxed in the country of consumption.[1014] These adjustments would generate trade neutrality: they level the playing field between products from different countries with regard to such taxes. Indeed, adjustments by all trading countries applied symmetrically at the import and export side ensure that products are not double taxed but could likewise not take advantage of low taxes in their country of origin.[1015]

However, the GATT/WTO disciplines only allow for border tax adjustments on *indirect taxes*, which are imposed directly or indirectly on products, but not on *direct taxes*, which are considered to be imposed upon the producer. Framed differently, the destination principle is installed with regard to indirect taxes, whereas the origin principle is applied to direct taxes. Direct taxes are imposed in the country of production and cannot be adjusted at either the import or export side. The rationale underpinning this distinction is twofold. First, the economic assumption holds that indirect taxes are fully shifted forward by the taxpayer into the final price charged to consumers (i.e., consumption tax), whereas direct taxes would be completely shifted backward and thus be borne by the producer (i.e., income tax). Direct

[1013] Referring *inter alia* to Article 1.1(a)(1)(iv) of the SCM Agreement and item (d) of the Illustrative List, the Appellate Body stated that '(i)n these provisions, some kind of government mandate, direction, or control is an element of a subsidy provided through a third party'. Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, para 128, footnote 113. Recall that the concept of 'direction' is interpreted broadly by the Appellate Body. Hence, there is no high degree of compulsion required under Article 1.1(a)(1)(iv) of the SCM Agreement (see above n 745).

[1014] See, for example, *Border Tax Adjustments, Report of the Working Party adopted on 2 December 1970* (L/3464), para 4.

[1015] See, for example, P. Demaret and R. Stewardson, 'Border Tax Adjustments under GATT and EC Law and General Implications for Environmental Taxes', 28:4 *Journal of World Trade* (1994), 5-64, at 6.

taxes would therefore not be reflected in the final price of the product.[1016] Already during the GATT era, however, GATT Contracting Parties understood that this assumption does not entirely hold because, for instance, direct taxes could very well be reflected in the final price.[1017] Second, this dichotomy might be partly explained on the basis of tradition: it codified GATT Contracting Parties' practices to only adjust for indirect taxes and not direct taxes.[1018]

Despite its questionable economic underpinning, which is voiced particularly by those countries such as the US relying predominantly on direct instead of indirect taxes, this dichotomy is still in place under the current WTO framework. WTO Members have the right – but not the obligation – to adjust indirect taxes on the import and/or export side and symmetric application on both sides is not even required. On the import side, Article II:2(b) *juncto* Article III:2 of the GATT allows WTO Members to impose an equivalent indirect tax upon imported products.[1019] More relevant for our discussion, several items of the Illustrative List elaborate upon Note Ad Article XVI of the GATT, which allows adjustments of indirect taxes on the export side.[1020] During the Doha negotiations, the US urged once more to stronger equalize the treatment on direct and indirect taxation under the SCM Agreement.[1021] Yet, it seems unlikely that this call will be answered given that the Draft Consolidated Chair Text does not amend the existing provisions.[1022] These provisions under the Illustrative List implementing the distinction between direct and indirect taxes are explained further.

First, item (e) installs the origin principle for direct taxes and social welfare charges.[1023] Their full or partial exemption specifically related to exports qualifies as a prohibited export

[1016] See *Note by the Secretariat, Taxes and Charges for Environmental Purposes – Border Tax Adjustment* (WT/CTE/W/47, 2 May 1997), para 36.
[1017] See, for example, *Border Tax Adjustments, Report of the Working Party adopted on 2 December 1970* (L/3464), para 8. See also J. Bhagwati and P. Mavroidis, 'Is Action Against US Exports for Failure to Sign Kyoto Protocol Legal?', 6:2 *World Trade Review* (2007), 299-310, at 306.
[1018] See, for example, *Border Tax Adjustments, Report of the Working Party adopted on 2 December 1970* (L/3464), para 8; Dam, above n 999, at 139.
[1019] The import side of border tax adjustments is not relevant for our discussion on export subsidies.
[1020] For an overview of the negotiating history, see G. C. Hufbauer, *Fundamental Tax Reform and Border Tax Adjustments* (Washington DC: Institute for International Economics, January 1996), 89 pp., at 47-50; Hufbauer and Erb, above n 542, at 51-57.
[1021] *Communication from the United States, Subsidies Disciplines Requiring Clarification and Improvement* (TN/RL/W/78, 19 March 2003), at 5.
[1022] Draft Consolidated Chair Text, above n 643.
[1023] Direct taxes cover, by virtue of footnote 59 of the SCM Agreement, 'taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property'. At the time of the Working Party Report on BTAs (1970s), it was still debated whether taxes on property and social security charges could be rebated. Yet, the SCM Agreement clarifies that both are excluded from adjustment upon exportation.

subsidy.[1024] Nonetheless, this prohibition does not intent to limit a Member from taking measures 'to avoid the double taxation of income earned by a taxpayer of that Member in a "foreign" State'.[1025,1026] The US invoked this exception formulated in footnote 59 as a defense with regard to the ETI measure. The Appellate Body indeed clarified that this constitutes an 'affirmative defense' that may justify a prohibited export subsidy and that the burden of proof is on the party invoking the exception.[1027] Yet, the US failed to meet this burden because the ETI exemption improperly combined domestic-source income and foreign-source income.[1028] The Appellate Body hereby ensured that if the measure would have been 'confined to those aspects which grant a tax exemption for "foreign-source income", it would fall within footnote 59'.[1029]

Turning to indirect taxes, the conditions to apply border tax adjustments (BTAs) on the export side are specified in items (g) and (h) of the Illustrative List. Item (g) sets out the general rule: 'the exemption or remission, with respect to the production and distribution of exported products, of *indirect taxes*' is considered a prohibited export subsidy only if it is 'in excess of those levied with respect to the production and distribution of like products when sold for domestic consumption'. Implementing the destination principle, this provision only prohibits excessive adjustment of indirect taxes on exported goods. Indirect taxes form the residual category of taxes under the SCM Agreement, covering 'sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes *and all taxes other*

[1024] A deferral is not an export subsidy where, for example, appropriate interest charges are collected. See footnote 59 of the SCM Agreement; Appellate Body Report, *US – FSC*, para 97. Also considered a prohibited export subsidy is 'the allowance of *special deductions* directly related to exports or export performance, over and above those granted in respect to production for domestic consumption, *in the calculation of the base on which direct taxes are charged*' (item f, emphasis added).
[1025] See Annex I(e), footnote 59 of the SCM Agreement, *in fine* as interpreted by the Appellate Body in *US – FSC (Article 21.5 – EC)*, paras 137-138. In particular, the Appellate Body clarified that *double taxation* occurs 'when the same income, in the hands of the same taxpayer, is liable to tax in different States'. Next, *foreign-source income* 'refers to income generated by activities of a non-resident taxpayer in a 'foreign' State which have such links with that State so that the income could properly be subject to tax in that State'. Appellate Body Report, *US – FSC (Article 21.5 – EC)*, paras 137 and 145.
[1026] In footnote 59, WTO Members also 'reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length'. See also Appellate Body Report, *US – FSC*, paras 98-100.
[1027] The US argued that the burden was on the complaining party but this was rejected by the Appellate Body. Appellate Body Report, *US – FSC (Article 21.5 – EC)*, paras 124, 126, 127, 133, 134.
[1028] Appellate Body Report, *US – FSC (Article 21.5 – EC)*, paras 184-186. The Panel had reached the same conclusion but seemed to put more emphasis on the *purpose* of the measure, namely, the avoidance of double taxation. Panel Report, *US – FSC (Article 21.5 – EC)*, paras 8.94–8.108. See Hudec, above n 693, at 201.
[1029] Reading some flexibility into footnote 59, the Appellate Body recognized that 'avoiding double taxation is not an exact science and we recognize that Members must have a degree of flexibility in tackling double taxation'. But this flexibility is not interpreted so widely as to allow WTO Members 'to adopt allocation rules that systematically result in a tax exemption for income that has no link with a "foreign" State'. Appellate Body Report, *US – FSC (Article 21.5 – EC)*, para 185.

than direct taxes and import charges'.[1030] Evidently, not only sales taxes, collected on the point of final sale, but also value-added taxes (VAT), which are collected on every stage of production and distribution on the value added, could be adjusted upon exportation within the limits set out under item (g).[1031] Under a system of BTAs upon exportation, no VAT is thus charged on exported products and the exporter could deduct the VAT paid on its inputs, implying that there is no residual VAT reflected in the export price. Observe that today almost 150 countries have set up a VAT system, including all OECD countries except for the US.[1032]

Item (h), on the other hand, implements the destination principle with regard to a specific type of indirect taxes, namely 'prior-stage cumulative indirect taxes' (PSCI taxes). These PSCI taxes may 'be exempted, remitted or deferred on exported products' even when no such adjustment is made when sold for domestic consumption, insofar they 'are levied on *inputs that are consumed* in the production of the exported product (making normal allowance for waste)'.[1033] The SCM Agreement hereby enlarged the scope of taxes that could be rebated under the Subsidies Code. Inputs 'consumed in the production process' encompass, according to footnote 61 of the SCM Agreement, not only 'inputs physically incorporated'[1034] but also 'energy, fuels and oil used in the production process and catalysts which are consumed in the course of their use to obtain the exported product'.[1035] It should be emphasized that the scope of item (h) is confined to *prior stage* indirect taxes, which are taxes levied on goods or services used directly or indirectly in making the product,[1036], that are also *cumulative* in nature. Such cumulative taxes are 'multi-staged taxes levied where there is no mechanism for subsequent crediting of the tax if the goods or services subject to tax at one stage of production are used in a succeeding stage of production'.[1037] The prototypical example of such PSCI tax is a *cascade* tax system. Whereas under VAT systems only taxes on *value-added* are levied on each stage of production, *cascade* taxes are sales taxes levied on the actual *output value* on each stage of the production process. Compared to VAT systems,

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[1030] Footnote 58 of the SCM Agreement (emphasis added). Concerning machinery and stamp taxes, there was also disagreement in the Working Party on BTAs (1970) whether these could be adjusted (see also above n 1023). Because these taxes are categorized under 'indirect taxes', they are eligible for adjustment upon exportation under the SCM Agreement.

[1031] Footnote 60 explicitly confirms that VAT is covered under item (h) and not under item (i). By its terms, VAT would also be excluded from the scope of item (i) because it is not a cumulative tax (see below).

[1032] OECD, 'Consumption Taxes: the Way of the Future?', *OECD Observer - Policy Brief* (October 2007), 1-7.

[1033] Emphasis added.

[1034] It is further clarified that inputs are physically incorporated 'if such inputs are used in the production process and are physically present in the product exported'. Annex II, para 3 of the SCM Agreement.

[1035] Contrast item (h) *juncto* footnote 61 of the SCM Agreement with item (h) of the Subsidies Code.

[1036] Footnote 58 of the SCM Agreement.

[1037] Footnote 58 of the SCM Agreement.

such cascade systems therefore bear a double disadvantage. They are not neutral on the length of the production process chain as each stage is taxed on the actual value. Next, such systems do not allow, on the final stage before exportation, to accurately calculate the tax amount levied during various stages of production, generating the risk that rebates on exports would be in excess of taxes incurred. For these reasons, OECD countries – but gradually developing countries as well – have replaced their cascade system by a VAT system.[1038] Some developing countries, however, still operate a cascade system because of a lack of administrative capacity to set up a more complex VAT system. Overall, the progressive conversion of cascade systems has reduced the relevance of item (h) of the Illustrative List.[1039]

By virtue of footnote 1 of the SCM Agreement, adjustments on indirect taxes in conformity with items (g) or (h) of the Illustrative List are neither countervailable nor actionable under the SCM Agreement. Hence, these rebates are not only exempted from the prohibition on export subsidies but from the scope of the SCM Agreement as a whole. In the concluding Part of this dissertation, the topical debate on whether carbon taxes could be rebated upon exportation by virtue of item (g) or (h) will be explored.[1040]

4.1.1.2.2.2. Duty drawback systems

Next to indirect taxes, the destination principle is equally applied with regard to import charges[1041] on inputs. This means that these could also be rebated upon exportation insofar they are consumed in the production of the exported product.[1042] Consequently, by virtue of item (i), such *a duty drawback system* is only prohibited if it results in excess drawback of the import charges initially levied on the imported input.[1043,1044] The justification for such rebates is similar as the one singled out for indirect taxes: import charges are borne by the product and most developed countries had such drawback system in place. If the aim is to level the

[1038] This explains why the EC already in the 1960s obliged its Member states to adopt a VAT system.
[1039] Take also into account that certain low-income WTO Members are exempted from the prohibition on export subsidies (see below Part II, Chapter 6, Section 6.1.1.1.1). Hence, they do not have to rely on item (h) in case they have a *cascade* tax system in place rebating taxes on exports. On the other hand, conformity with item (h) *juncto* footnote 1 of the SCM Agreement would place their cascade taxes outside the reach of CVDs action and actionable subsidy claims. In this respect, item (h) might still be relevant for those developing countries benefiting from S&D treatment.
[1040] See below Part IV, Chapter 2, Section 2.1.1.2.3.
[1041] Footnote 58 of the SCM Agreement stipulates that import charges 'mean tariffs, duties, and other fiscal charges not elsewhere enumerated in this note that are levied on imports'.
[1042] See also above n 716.
[1043] Again, 'normal allowance for waste' is treated as consumed in the production process. The concepts of 'waste' and 'normal' are defined in respectively paragraph 4 and paragraph 5 of Annex II of the SCM Agreement.
[1044] See also Article VI:4 of the GATT. The US already inscribed a duty drawback provision in 1789. See Hufbauer and Erb, above n 542, at 63.

playing field between exporters (i.e., trade neutrality), not only indirect taxes but also import charges should be rebated upon exports. After all, import charges are in essence a combination of a consumption tax with a production subsidy.[1045] Yet, because such drawback systems often went beyond ensuring a level playing field, excess drawbacks have been explicitly condemned as export subsidies since the 1960 Declaration. This prohibition on excess drawbacks is thus currently incorporated in item (i) of the Illustrative List.

To ease the administrative burden upon exporters, such an excess drawback is, nonetheless, allowed under item (i) if a firm uses a quantity of home market inputs as a substitute for imported inputs.[1046] To prevent disguised subsidization, such *substitution drawback systems* have to respect three conditions by virtue of item (i): the quantity of domestic and imported inputs should be equal, domestic and imported inputs should have the same quality and characteristics, and the import and corresponding export operation should both occur within a reasonable period of time, not exceeding two years. The (outdated)[1047] idea behind such substitution drawback system is that exporters are not required to ensure that a particular amount of imported inputs is effectively used in the production of the exported product for which a drawback is requested. Overall, however, the conditions imposed upon such substitution drawback system should guarantee that no drawback will occur in excess of levied import charges on inputs. Annex III of the SCM Agreement spells out specific guidelines for the determination whether a substitution drawback system qualifies as an export subsidy under item (i) of the Illustrative List.

Notably, drawback systems are also confined to inputs that are 'consumed in the production of the exported products' (item (i) *juncto* Annex II of the SCM Agreement), which covers 'inputs physically incorporated, energy, fuels and oil used in the production process and catalysts which are consumed in the course of their use to obtain the exported product' (footnote 61 of the SCM Agreement). Consequently, import charges on capital inputs could not be rebated since these are not physically incorporated in the processed products. To remove this discrepancy, India has put forth a proposal to expand the scope of drawbacks to import duties paid on capital inputs.[1048] Observing only some administrative difficulties in implementation, the IMF concurred that this proposal is indeed solid on economic grounds.

[1045] See above Part I, Chapter 1. See also *Communication from the International Monetary Fund, Export Financing and Duty Drawbacks* (WT/TF/COH/15, 14 February 2003), at 7-8.

[1046] This was already inscribed in the Subsidies Code. The US adopted a domestic substitution provision in the 1930s. See Hufbauer and Erb, above n 542, at 64.

[1047] Already in the beginning of the 1980s, Hufbauer and Erb questioned the legitimacy of domestic substitution systems because modern accounting methods made it much easier to separate inventories on domestic and imported inputs. See Hufbauer and Erb, above n 542, at 64-65.

[1048] For the latest version of this proposal, see *Submission by India, Verification System of Duty Rebate Schemes and Definition of Inputs Consumed under ASCM, Revision* (TN/RL/GEN/153/Rev.1, 13 March 2008). The initial proposal can be found in *Discussion paper submitted by India* (G/SCM/W/430, 9 March 2001).

No economic rationale is available on why drawbacks systems should be restricted to inputs consumed in the production process.[1049] After all, physical capital goods that are used up (i.e., depreciate) in the production process and other inputs such as computer software add as much to the final cost of the product as do inputs physically incorporated.[1050] For two obvious reasons, developed countries are, however, not keen to agree with this proposed amendment. First, given that their import charges on capital goods are much lower, their exporters using such capital inputs compete on a better than level playing field with exporters from developing countries such as India.[1051] Second, allowing duty drawbacks on capital inputs would ease the internal pressure by developing countries' exporters upon their government to lower import charges on capital inputs. Hence, developed countries tactically remarked that developing countries' concern could simply be addressed through lowering import charges on capital goods. India refuted this suggestion by pointing to the importance of tariff revenue for developing countries' budgets.[1052] Given the opposed interests of WTO Members, it comes as no surprise that the Draft Consolidated Chair Text does not make capital inputs eligible for drawback along the lines suggested by India. Indeed, the latest draft circulating in the negotiations leaves the definition of 'inputs consumed in the production process' under footnote 61 of the SCM Agreement untouched.[1053]

In addition to expanding the scope of inputs available for drawback, India has proposed to explicitly allow for a uniform drawback rate imposed upon exporters collectively, so that an individual rate for each and every exporter should no longer be calculated.[1054] Especially for small exporters, the costs of keeping track of inputs eligible for drawback would be too high. Once more, the IMF agreed with the rationale of this proposal.[1055] The requirements for an individual drawback rate might be onerous for developing countries, potentially leading to delays in calculating the drawback rate and thus hurting the competitive position of their

[1049] *Communication from the International Monetary Fund, Export Financing and Duty Drawbacks* (WT/TF/COH/15, 14 February 2003), at 10-11.
[1050] *Communication from the International Monetary Fund, Export Financing and Duty Drawbacks* (WT/TF/COH/15, 14 February 2003), at 10.
[1051] Recall that LDCs and certain low-income countries benefit from S&D treatment regarding export subsidies (see below Part II, Chapter 6, Section 6.1). Rebating import charges upon capital inputs is thus not prohibited for these countries but still vulnerable to CVDs action and actionable subsidy claims.
[1052] *Submission by India, Verification System of Duty Rebate Schemes and Definition of Inputs Consumed under ASCM, Revision* (TN/RL/GEN/153/Rev.1, 13 March 2008), para 6; *Discussion Paper Submitted by India* (G/SCM/W/430, 9 March 2001), para 3.2.
[1053] Draft Consolidated Chair Text, above n 643.
[1054] *Submission by India, Verification System of Duty Rebate Schemes and Definition of Inputs Consumed under ASCM, Revision* (TN/RL/GEN/153/Rev.1, 13 March 2008); *Discussion paper Submitted by India* (G/SCM/W/430, 9 March 2001).
[1055] *Communication from the International Monetary Fund, Export Financing and Duty Drawbacks* (WT/TF/COH/15, 14 February 2003), at 8-9.

exporters. Next to lowering the administrative burden, the IMF saw merit in the proposal for political-economy reasons because a collective rate would reduce the risk of rent-seeking behaviour by individual exporters. The IMF therefore proposed a hybrid system. An individual rate could be calculated for large exporters as they have to keep track of the necessary records for VAT purposes anyway, whereas for small exporters a uniform drawback rate should indeed be an option. But again, India's proposal for a collective drawback rate has not found its way to the Draft Consolidated Chair Text.[1056]

4.1.1.2.3. The (potential) direct transfer of funds: Export credit support

Finally, two items of the Illustrative List predominantly deal with official export credit support and in essence spell out a cost-to-government standard to determine whether such support is prohibited (item (j) and (k)). Both items discipline different forms of export credit support: item (j) deals with so-called 'pure cover support' (i.e., export credit guarantees/insurance) and item (k) sets restrictions on 'official financing support' (e.g., direct export credits). These items will be discussed in depth under Part III and are therefore only shortly introduced below.

First, government guarantees[1057] or insurance programmes covering potential default on credits extended to foreign buyers are considered prohibited export subsidies under item (j) if they are offered at premium rates inadequate to cover the long-term operating costs and losses of the programmes. The evaluation of such 'pure cover support' is thus made at an aggregate level and looks at the overall cost to the government: are premiums charged for government guarantees/insurance sufficient to cover the costs of the programme?[1058] Notice that the same standard is prescribed under item (j) with regard to insurance/guarantee programmes against increases in the cost of exported products and exchange risk programmes.

Second, item (k) prohibits governments to offer direct export credits if these are granted at rates below those the government in question actually has to pay for the funds so used or, alternatively, below those the government would have to pay if it borrowed similar funds on international capital markets. Such direct export credits would only violate item (k) insofar

[1056] Draft Consolidated Chair Text, above n 643.
[1057] The Panel in *Korea – Commercial Vessels* clarified that 'an instrument will guarantee an export credit if it covers default by a borrower in respect of an export credit provided to that borrower'. Panel Report, *Korea – Commercial Vessels*, para 7.213.
[1058] Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para 93; Appellate Body Report, *US – Upland Cotton*, paras 666 and 667.

they are 'used to secure a material advantage in the field of export credit terms'.[1059] Additionally, government payments of the cost incurred by exporters or financial institutions in obtaining credits likewise qualify as export subsidies under item (k). Again, this only kicks in when these payments are used to secure a material advantage in the field of export credit terms.

Notwithstanding the benchmarks for export credit practices articulated under item (j) and paragraph 1 of item (k), some of these practices are not prohibited by virtue of paragraph 2 of item (k). This paragraph carves out a safe haven for certain export credit conforming to the Arrangement on Guidelines for Officially Supported Export Credit (OECD Arrangement). To benefit from this safe haven, export credit support should be *subject* to the OECD Arrangement's interest rate obligations and *conform* to its general disciplines. Because export credit guarantees/insurances are currently not subject to the interest rate provisions, such support cannot rely on this exemption. This means that this safe haven cannot be invoked to justify 'pure cover' export credit support violating item (j) and/or Article 1 *juncto* 3 of the SCM Agreement. The exact scope of this safe haven is further delineated in Part III.

4.1.1.3. Export subsidies not prohibited under the Illustrative List

The previous discussion has shown that the Illustrative List elaborates a non-exhaustive list of export subsidies *per se* prohibited under the SCM Agreement. Nonetheless, fiercely disputed before different panels is to what extent the Illustrative List could be used not to demonstrate that a subsidy is prohibited but, *a contrario*, to justify that a subsidy is *not* prohibited pursuant to Article 3.1(a) of the SCM Agreement. Footnote 5 of the SCM Agreement only partly solves this question since it is open for different interpretations: '(m)easures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement'. On the one hand, one could adopt an expansive interpretation of 'referring' because the Illustrative List deals with certain specific types of subsidies (e.g., direct export credits) and therefore sets 'a dispositive legal standard' to determine whether these are prohibited or not.[1060] This expansive reading endorsed by both Brazil (*Brazil – Aircraft* case) and Korea (*Korea – Commercial Vessels* case) would allow for an *a contrario*-reading of all aspects of the Illustrative List. For example, if the standard of item (k), para 1, would *not* be met (e.g., no cost to the government), a direct export credit would *not* be

[1059] The Panel in *Korea – Commercial Vessels* held, without any explanation, that the material clause also applies to the first aspect of item (k), paragraph 1. Panel Report, *Korea – Commercial Vessels*, para 7.314.

[1060] This was argued by Brazil and the US. See Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para 6.38. The US indicated (para 6.39) that the negotiating history supports a broad interpretation since a draft version (Cartland III) read as '(m)easures *expressly* referred (…)' and the word 'expressly' was dropped in Cartland IV.

prohibited even if it would qualify as an export subsidy within the meaning of Article 1 *juncto* Article 3.1(a) of the SCM Agreement. However, panels have systematically rejected such an *a contrario* defense for all items of the Illustrative List. In their reading, the text of footnote 5 requires an *affirmative* statement that a measure is not subject to the Article 3.1(a) prohibition, that it is not prohibited, or that it is allowed.[1061] Only if such an affirmative statement is formulated under an item of the Illustrative List, could it be used to show, *a contrario*, that a subsidy is *not* prohibited.

Because of the lack of such an affirmative statement, panels have, on the one hand, decided that item (j), dealing with pure cover support, and the first paragraph of item (k), dealing with official financing support, could not be used *a contrario*:[1062] if export credit support does not meet all the criteria set by item (j) or (k, para 1), it could still constitute a prohibited export subsidy in case it is demonstrated to be a subsidy contingent upon export performance (Article 1 *juncto* 3 of the SCM Agreement). For example, an export credit guarantee under a programme that runs break-even, as prescribed under item (j), is prohibited pursuant to Article 3.1(a) of the SCM Agreement if it is a subsidy in the meaning of Article 1 SCM Agreement and contingent upon exportation. Until present, the Appellate Body has not yet revealed whether it would agree that an *a contrario*-reading of items (j) and (k), paragraph 1 should indeed be rejected.[1063] Through analyzing other arguments next to the text of footnote 5 of the SCM Agreement, it will be revealed in Part III why the panels' rejection of such an *a contrario* claim is indeed correct.[1064]

On the other hand, panels have pointed to some items containing affirmative statements that a measure is not an export subsidy or that it is allowed. Hence, these items could thus be relied upon to formulate an *a contrario* reasoning. First of all, the safe haven for export credits in

[1061] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, paras 6.36 and 6.38.

[1062] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, paras 6.36-6.37; Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, paras 5.269-5.275; Panel Report, *Korea – Commercial Vessels*, para 7.198.

[1063] The Appellate Body stated that if Brazil had discharged its burden to show that its financing programme did not secure a material advantage, it would 'have been prepared to find that the payments made under the *(financing programme)* are justified under item (k) *(paragraph 1)* of the Illustrative List' (emphasis added) and thus seems to accept an *a contrario* defense. Yet, the Appellate Body continued that 'in making this observation, we wish to emphasize that we are not interpreting footnote 5 of the SCM Agreement, and we do not opine on the scope of footnote 5, or on the meaning of any other items in the Illustrative List'. The Panel in *Brazil– Aircraft (Article 21.5 – Canada II)* referred to this statement and acknowledged that 'it could be understood in the manner suggested by Brazil' but noted that 'the Appellate Body's statement does not form part of the legal basis for its disposition of the appeal, nor did the Appellate Body explain its statement'. Pointing to the second part of the Appellate Body's reasoning, the Panel in *Korea – Commercial Vessels* also decided that the Appellate Body has not rejected the interpretation of previous panels. See Appellate Body Report, *Brazil – Aircraft (Article 21.5 – Canada)*, paras 80-81; Appellate Body Report, *US – Upland Cotton*, para 731; Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, footnote 214; Panel Report, *Korea – Commercial Vessels*, paras 7.193–7.207.

[1064] See below Part III, Chapter 4, Section 4.3.3.1.

conformity with the interest rate provisions of the OECD Arrangement inscribed in the second paragraph of item (k) is such an affirmative statement.[1065] Thus, if export credit support is covered under this safe haven, it shall not be prohibited under the SCM Agreement. Likewise, the Panel in *Brazil – Aircraft (Article 21.5 – Canada)* detected an affirmative statement in item (h), dealing with border tax adjustments on prior-stage cumulative indirect taxes, as well as in item (i), in the part dealing with substitution drawbacks systems.[1066] Again, such border tax adjustments or substitution drawbacks systems are therefore not prohibited under the SCM Agreement. Lastly, the same Panel referred to affirmative statements in footnote 59, which offer exceptions to the principle prohibition on border tax adjustments on direct taxes and social welfare charges.[1067] The first sentence indicates that the deferral specially related to exports of direct taxes or social welfare charges is not an export subsidy where, for example, appropriate interest charges are collected. Next, the last sentence of footnote 59 sets out the exception of measures imposed to avoid double taxation of foreign-source income. Although the Panel in *Brazil – Aircraft (Article 21.5 – Canada)* listed these provisions as *examples*, it is hard to detect other types of affirmative statements in the Illustrative List.

In sum, this limited group of provisions could be used to demonstrate that a measure is not *prohibited* under the SCM Agreement. However, are measures falling under one of these affirmative statements also shielded from a challenge on the basis of the actionable subsidy provisions (multilateral) and/or a countervailing duty response (unilateral)? Here, a distinction has to be made. On the one hand, the affirmative statements in items (h) and (i) should be read together with footnote 1 of the SCM Agreement. Indeed, border tax adjustments and duty drawback systems in conformity with the Illustrative List are simply exempted from the subsidy definition and can, therefore, neither be challenged under the actionable subsidy provisions nor be countervailed.[1068] On the other hand, with regard to the other affirmative statements, in particular the double income tax exemption (footnote 59) and the safe haven for export credit support (item (k), para 2), such multilateral and unilateral actions seem not *ipso facto* foreclosed. Whereas this conclusion needs some further analysis as will be undertaken in Part III,[1069] notice for now that this seems to be implied in the Appellate Body's statement in *US – FSC*:

> Under footnote 5 of the *SCM Agreement*, where the Illustrative List indicates that a measure is not a prohibited *export* subsidy, that measure is *not* deemed, for that reason alone, not to be a

[1065] See Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para 6.36.
[1066] See Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para 6.36, footnotes 35, 36.
[1067] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para 6.36, footnote 34.
[1068] See also Appellate Body Report, *US – FSC,* para 93; Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para 6.36, footnote 37.
[1069] See below Part III, Chapter 4, Section 4.4.

> "subsidy". Rather, the measure is simply *not prohibited* under the Agreement. Other provisions of the *SCM Agreement* may, however, still apply to such a "subsidy".[1070]

These 'other provisions' referred to by the Appellate Body include the provisions on actionable subsidies (Part III) as well as on the imposition of countervailing measures (Part V).[1071] Hence, the Appellate Body left open the possibility that a double income tax exemption in conformity with footnote 59 could still be a 'subsidy' under Article 1 of the SCM Agreement and thus be actionable or countervailable if causing adverse effects or injury to the domestic industry. Next, as discussed more in-depth in Part III of this study, export credit support justified under the safe haven might also still be actionable and countervailable.

In sum, the affirmative statements singled out above could be used *a contrario*, namely to show that a measure is not prohibited under the SCM Agreement. Border tax adjustments and duty drawback systems are simply excluded from the subsidy definition.[1072] Other affirmative statements shield measures from the prohibited subsidy category but do not exclude that they might be actionable and/or countervailable.[1073] Noteworthy, the Draft Consolidated Chair Text would amend the current footnote 5 of the SCM Agreement along the lines consistently interpreted by different panels. The new text of this footnote would read in the relevant parts:

> Annex I shall *not be used to establish by negative implication* that a measure does not constitute an export subsidy within the meaning of that paragraph; provided, however, that measures *explicitly* referred to in Annex I as not constituting prohibited export subsidies shall not be prohibited under this or any other provision of this Agreement. This footnote is without prejudice to the operation of footnote 1.[1074]

This indeed confirms that the Illustrative List could in principle not be used *a contrario*. Only measures *explicitly* referred to in the Illustrative List as not constituting prohibited export subsidies could be used *a contrario*. Moreover, the clarification that this footnote is without prejudice to the operation of footnote 1 confirms that border tax adjustments and duty drawback systems in conformity with the Illustrative List are simply excluded from the scope of the SCM Agreement.

1070 Appellate Body Report, *US – FSC,* para 93. See also Decision by the Arbitrators, *Brazil – Aircraft (Article 22.6 – Brazil)*, para 3.39.
1071 Appellate Body Report, *US – FSC,* para 93.
1072 Obviously, this conclusion also holds on the basis of footnote 1 of the SCM Agreement for border tax adjustments and duty drawback systems containing no affirmative statement (e.g., item (g)).
1073 The same conclusion holds for agricultural export subsidies not prohibited under the Agreement on Agriculture (see below Part II, Chapter 6, Section 6.2.3.1).
1074 Draft Consolidated Chair Text, above n 643 (emphasis added).

4.1.2. Local content subsidies

The other category of prohibited subsidies are local content subsidies, defined as subsidies contingent upon the use of domestic over imported goods (Article 3.1(b)).[1075] In fact, this is the only form of domestic subsidies that is prohibited.[1076] The US was one of the proponents during the Uruguay Round to include them in the category of prohibited subsidies, arguing that these subsidies 'are as effective as any tariff in protecting domestic input supplying industries and distorting the flow of resources internationally'.[1077] The citation reveals that this type of subsidy is conceptually different from other kinds of subsidies. It does not focus on the receiver of the subsidy but on the domestic input-supplying industries. In other words, what is targeted is trade distortion in the input industry market and not in the market of the industry receiving the beneficial financial contribution by the government.[1078] These subsidies clearly violate the GATT's national treatment provision (Article III:4) because the regulations at hand discriminate between the domestic and foreign input supplying industry. As confirmed by the Panel in *Indonesia – Autos*, the exception provided by Article III:8(b) of the GATT is not applicable because the discrimination exists between the domestic and foreign input industries and not between the subsidized industry and the foreign industry.[1079] Moreover, local content subsidies are covered by the Illustrative List of the Agreement on Trade-Related Investment Measures (TRIMs Agreement) that are inconsistent with Article III:4 of the GATT (as local content requirements).[1080,1081] However, in contrast to the GATT

[1075] For a discussion on the relationship between the TRIMs Agreement and the SCM Agreement, see P. Sauvé, *Trade Rules Behind Borders: Essays on Services, Investment and the New Trade Agenda* (London, Cameron May, 2003), 666 pp., at 313–318.
[1076] Local content subsidies might in addition be contingent on export performance and thus constitute export subsidies (Article 3.1(a) of the SCM Agreement). As mentioned above, 'contingency' does not require that import substitution should be a sufficient condition to receive the subsidy. So, export performance can be an additional requirement. See, for example, the *Canada – Autos* case.
[1077] Stewart, above n 579, at 889.
[1078] For instance, such a subsidy would no longer be prohibited if the local content condition would be deleted. Of course, such a subsidy could still be challenged as an actionable or export subsidy (see also above n 1076).
[1079] The GATT Panel in *Italy – Agricultural Machinery* stated that Article III:8 of the GATT was not applicable because the credit facilities were 'granted to *the purchasers* of agricultural machinery and could not be considered as subsidies accorded to *the producers* of agricultural machinery' (emphasis added). GATT Panel Report, *Italy – Agricultural Machinery*, para 14. According to the Panel in *Indonesia – Autos*: 'the purpose of Article III:8(b) is to confirm that subsidies to producers do not violate Article III, so long as they do not have any component that introduces discrimination between imported and domestic products'. See Panel Report, *Indonesia – Autos*, para 14.43. The World Trade Report 2006 also considered that local content subsidies are covered by Article III:4 of the GATT 1994. World Trade Report 2006, above n 574, at 192.
[1080] See Article 2 *juncto* paragraph 1(a) of the Illustrative List of the TRIMs Agreement. For the relationship between the TRIMs Agreement and SCM Agreement, see Panel Report, *Indonesia – Autos*, paras 14.49-14.55. The Panel concluded that measures challenged under both the TRIMs Agreement and the SCM Agreement must be reviewed under both.
[1081] This has to be nuanced insofar S&D treatment under the TRIMs Agreement is still in place (see below Part II, Chapter 6, Section 6.1.1.2).

and the TRIMs Agreement, the SCM Agreement does not provide any ground for justification for local content subsidies and has specific and stricter dispute settlement provisions in place.[1082]

4.2. ACTIONABLE SUBSIDIES

Actionable subsidies are defined by default in Part III of the SCM Agreement: if a specific subsidy within the meaning of Articles 1 and 2 of the SCM Agreement is *not* prohibited, it constitutes an actionable subsidy.[1083] This means that such amber light subsidies can be subject to multilateral action *if* they cause 'adverse effects' to the interests of other WTO Members.[1084] As the Panel in *US – Upland Cotton* has explained, 'the focus on the trade effects of subsidization in Article XVI:1 of the GATT 1994 on any other Member is carried into Part III of the SCM Agreement'.[1085] The main onus upon the complaining Member is indeed to demonstrate such 'adverse effects' (Article 5 of the SCM Agreement). This covers three situations: (a) injury to the domestic industry; (b) nullification or impairment of benefits accruing to other WTO Member(s); and (c) serious prejudice to the interests of another WTO Member.[1086] The first two types of harm largely codify the rules and practice under the GATT regime.[1087,1088] The 'serious prejudice' category, on the other hand, significantly expands the scope of domestic subsidies that could be challenged.

4.2.1. Injury to the domestic industry

The term injury to the domestic industry is used in the same way as in the context of CVDs procedures.[1089] It will be explained in the discussion on CVDs action that 'injury' covers

[1082] See below Part II, Chapter 5. A violation of Article III:4 of the GATT or Article 2 of the TRIMs can still be justified on the basis of the general exceptions (Article XX of the GATT and Article 3 of the TRIMs) or balance-of-payments exception (Articles XII and XVIII:B of the GATT and Article 4 of the TRIMs). The question on the applicability of Article XX of the GATT to violations of the SCM Agreement is not yet settled in the case law but this option should be rejected in my view.
[1083] Even prohibited subsidies could *in theory* still be challenged as actionable subsidies. See Panel Report, *Korea – Commercial Vessels*, para 7.334.
[1084] In the words of the Appellate Body, 'they are actionable to the extent they cause adverse effect'. Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil),* para 238.
[1085] Panel Report, *US – Upland Cotton*, para 7.1405, footnote 1503. See also Panel Report, *Indonesia – Autos*, para 14.200.
[1086] Article 5 of the SCM Agreement.
[1087] To be precise, only CVDs action could be undertaken to respond to injury to the domestic industry under the original GATT disciplines. The substantive disciplines on domestic subsidies under the Subsidies Code were rather ineffective.
[1088] See also A. Hoda and R. Ahuja, 'Agreement on Subsidies and Countervailing Measures: Need for Clarification and Improvement', 39:6 *Journal of World Trade* 1009 (2005), 1009-1969, at 1060.
[1089] Article 5(a), footnote 11 of the SCM Agreement. See Part V and Article 15 of the SCM Agreement.

material injury as well as 'a threat' of material injury to a domestic industry.[1090] Instead of undertaking a CVDs procedure (unilateral remedy), WTO Members can thus opt for the WTO dispute-settlement system (multilateral remedy) and demonstrate injury to their domestic industry. In practice, WTO Members having CVDs procedures in place will more easily opt for the CVDs track to respond to adverse effect to their domestic industry. This unilateral track is not only faster but the imposition of CVDs also generates income and could effectively undo the adverse effect to the domestic industry. Removal of the adverse effects is, on the other hand, far less certain in case the time-consuming multilateral track is followed.

4.2.2. Nullification or impairment of benefits

The concept of nullification or impairment of benefits is formulated in the same sense as in the GATT.[1091] This concept is applied in non-violation complaints (NVCs) (Article XXIII:1(b) of the GATT) where three elements are established: (i) the use of a subsidy,[1092] (ii) the existence of a benefit accruing under the applicable agreement such as tariff concessions,[1093] and (iii) the nullification or impairment of a benefit (e.g., tariff concessions) as a result of the use of a subsidy (i.e., causation element).[1094] Because the non-violation remedy should remain of 'an exceptional nature',[1095] the standard for determining the element of causation (iii) is set high by the adjudicating bodies: 'non-violation nullification or impairment would arise when the effect of a tariff concession is *systematically* offset or counteracted by a subsidy program'.[1096] There is a double motivation behind NVCs. First, WTO Members have reasonable expectations that they can benefit from binding tariff concessions made by trade partners.[1097] Second, these WTO Members have 'paid' for the binding by making tariff concessions themselves. If trade partners offer tariff bindings for a product and would subsequently be allowed to subsidize so as to reduce market access for imports of the same product, the dynamism of reciprocal tariff concessions would be

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[1090] Article 15, footnote 45 of the SCM Agreement. 'Injury' shall be interpreted in accordance with Article 15 of the SCM Agreement.

[1091] Footnote 12 of the SCM Agreement.

[1092] Panel Report, *US – Offset Act (Byrd Amendment)*, paras 7.121-7.123.

[1093] Panel Report, *US – Offset Act (Byrd Amendment)*, para 7.124.

[1094] Panel Report, *US – Offset Act (Byrd Amendment)*, paras 7.125-7.131. All non-violation complaints in the GATT period concerned subsidies that were claimed to nullify a prior negotiated concession. P. C. Mavroidis, *Trade in Goods* (Oxford: Oxford University Press, 2007), 506 pp., at 413. For an interesting discussion of the first GATT case (*Australia – Ammonium Sulphate*, adopted 3 April 1950), see R. E. Hudec, *The GATT Legal System and World Trade Diplomacy* (New York: Praeger Publishers, 1975), 399 pp., at 144-153.

[1095] Panel Report, *US – Offset Act (Byrd Amendment)*, para 7.127.

[1096] Panel Report, *US – Offset Act*, para 7.127 (emphasis added); GATT Panel Report, *EEC – Oilseeds I*, para 148.

[1097] GATT Panel Report, *EEC – Oilseeds I*, para 148. According to Mavroidis, the non-violation complaint is an application of the *good faith* principle. Mavroidis, above n 1094, at 412.

undermined.[1098] As explained above, the NVC under the original GATT 1947 was precisely deemed useful to prevent domestic subsidies from eroding tariff concessions.[1099] No other multilateral action could be undertaken under the original GATT framework against foreign subsidization.

In conclusion, whereas the first type of adverse effect is that caused in the *domestic market* of other WTO Members, this second type tackles adverse effects to the export industry of other WTO Members in the *market of the subsidizing country*. Yet, the latter is confined to the situation where benefits accruing under the GATT are nullified. The 'serious prejudice' type of adverse effects, introduced in a rudimentary form in the Subsidies Code, expands the scope to effects occurring in third countries as well as in the subsidizing country even when no other benefits are nullified.[1100]

4.2.3. Serious prejudice

Originally, the SCM Agreement provided for a rebuttable presumption[1101] that 'serious prejudice' exists in the following cases: (a) the total *ad valorem* subsidization of a product exceeds 5 per cent; (b) the subsidy covers operating losses sustained by an industry; (c) the subsidy covers operating losses sustained by an enterprise, other than one time measures; or (d) direct debt forgiveness.[1102] This provision facilitated the difficult demonstration of adverse effects. Indeed, the complaining Member only had to demonstrate the existence of such a specific subsidy and could thus leave it upon the defending party to refute the trade effects. Yet, this so-called 'dark amber' category set out in Article 6.1 expired at the end of 1999 because there was no consensus among WTO Members to continue its existence. From the perspective of WTO law, it is rather exceptional that a stricter discipline is subject to extinction. However, the drafters of the SCM Agreement considered this stricter discipline (Article 6.1 of the SCM Agreement), which reflected in a diluted form the quantitative approach suggested by the US, as a *quid quo pro* for the inclusion of non-actionable subsidies (Article 8 of the SCM Agreement), insisted upon by other negotiating countries.[1103] Their future was thus bound together, and both expired after a period of five years because WTO Members did not extend their application.[1104] As indicated above, the US proposed in the

[1098] Matsushita, Schoenbaum, and Mavroidis, above n 721, at 279.
[1099] See above Part II, Chapter 1, Section 1.1.
[1100] A more effective way to challenge such types of adverse effects was mainly demanded by the US during the Uruguay Round. See *Submission by the United States* (MTN.GNG/NG10/W/40, 5 October 1990).
[1101] Article 6.1 *juncto* 6.2 of the SCM Agreement.
[1102] Article 6.1 of the SCM Agreement.
[1103] Article 31 of the SCM Agreement.
[1104] See also Panel Report, *Korea – Commercial Vessels,* para 7.583. See Hoda and Ahuja, above n 1088, at 1061.

current Doha round to move all but one of these 'dark amber' subsidies to the category of prohibited subsidies.[1105] To be sure, this proposal did apparently not find consensus among WTO Members. The Draft Chair Negotiating Text would not even reintroduce their 'dark amber' status (i.e., presumption of serious prejudice). Moreover, in light of the recent US bailouts in the car industry, it seems highly unlikely that the US could still seriously endorse its proposal dating from before the financial and economic crisis. After all, some of its own interventions would simply have been prohibited if its proposal would have been in force.[1106]

Today, it is thus always the task of the complaining party to demonstrate that the subsidy causes serious prejudice or a threat of serious prejudice.[1107] Such serious prejudice is present pursuant to Article 6.3 of the SCM Agreement if one of the following cases applies:[1108]

> (a) the effect of the subsidy is to *displace or impede the imports* of a like product of another Member into the market of the *subsidizing Member*;
> (b) the effect of the subsidy is to *displace or impede the exports* of a like product of another Member from a *third country market*;[1109]
> (c) the effect of the subsidy is *a significant price undercutting* by the subsidized product as compared with the price of a like product of another Member in the same market or *significant price suppression, price depression, or lost sales* in the same market;[1110]
> (d) the effect of the subsidy is *an increase in the world market share* of the subsidizing Member in a particular subsidized primary product or commodity as compared to the average share it had during the previous period of three years, and this increase follows a consistent trend over a period when subsidies have been granted.[1111]

1105 *Communication from the United States, Subsidies Disciplines Requiring Clarification and Improvement* (TN/RL/W/78, 19 March 2003); *Paper from the United States, Expanding the Prohibited "red light" Subsidy Category* (TN/RL/GEN/94, 16 January 2006); *Proposal from the United States, Expanding the Prohibited "red light" Subsidy Category, Draft Text* (TN/RL/GEN/146, 5 June 2007). Reflecting upon the US proposal, the EC expressed that it saw merit in revisiting the range of actions available to address the distorting effect of industrial subsidies. See *Submission by the European Communities, Subsidies* (TN/RL/GEN/135, 24 April 2006). Canada also endorsed the re-introduction of the presumption and the expansion of the list of Article 6.1. See *Communication from Canada* (TN/RL/GEN/112/Rev.1, 17 May 2006); *Communication from Canada* (TN/RL/GEN/14, 15 September 2004).

1106 See also below Part IV, Chapter 5.

1107 The rebuttable presumption shifted the burden of proof to the subsidizing party, which had to prove that the subsidization did not result in any of the effects described in Article 6.3 of the SCM Agreement (see Article 6.2 of the SCM Agreement).

1108 The wording 'may' in the opening sentence of Article 6.3 of the SCM Agreement suggests that this list is not exhaustive. The Panel in *US – Upland Cotton* therefore decided that it indeed also included a threat of serious prejudice (according to footnote 13 of the SCM Agreement) but left open whether also other situations could exist in which serious prejudice could be established. Panel Report, *US – Upland Cotton*, para 7.1388 (see footnote 1489 for the negotiating history). In light of the large variety of adverse trade effects summed under the four situations of Article 6.3 of the SCM Agreement, the list seems *de facto* closed once a threat of serious of prejudice is taken on board.

1109 See also Article 6.4 of the SCM Agreement.

1110 See also Article 6.5 of the SCM Agreement.

1111 Emphasis added, original footnote deleted. As the Panel in *Korea – Commercial Vessels* interpreted, 'the situations listed in Article 6.3(a)-(d) *are* serious prejudice in the sense of Article 5(c)'. Panel Report, *Korea – Commercial Vessels*, para 7.581 (emphasis in the original).

The case law has confirmed that 'serious prejudice' under Article 6.3, and by implication 'adverse effects' under Article 5(c), is *present* if one of these four types is demonstrated, without the need of establishing any additional element.[1112] The focus of these types of 'serious prejudice' is on the trade effects of subsidization.[1113] Subsidization could have effects on *volume* [items (a), (b), lost sales under (c), and (d)] as well as on *prices* [item (c)] that are adverse from the perspective of other WTO Members' trade interests.[1114] To formulate a successful 'serious prejudice' claim, the presence of one of the four listed volume/price situations should be demonstrated and, as the text explicitly prescribes, these should be 'the effect of the subsidy' (i.e., causation element). Because of the use of the present tense in Article 6.3 (i.e., the effect of the subsidy *is*), the relevant period for this demonstration is the present period.[1115] An important omission is that the SCM Agreement, again, does not clarify the required strength of the causal link. Another unsettled element is whether the volume or price effect should/could be analyzed separately from the causation element. The Appellate Body in *US – Upland Cotton* has observed that, contrary to the CVDs context, no specific causation requirements (e.g., non-attribution requirement[1116]) and thus 'no sequence of steps'[1117] are spelled out for the serious prejudice analysis under either Article 5(c) or 6.3 of the SCM Agreement.[1118] This means that panels have 'a certain degree of discretion in selecting an appropriate methodology'[1119] for tackling the causation element. In principle, panels are therefore free to opt for a *bifurcated* approach, in which they analyse both steps separately (as the Panel did in *US – Upland Cotton*), or to choose for a *unitary* approach (as the Panel did in *US – Upland Cotton (Article 21.5 – Brazil)*) and analyse both steps together.[1120] Regarding the required strength of the causal link, insights offered by the *US – Upland Cotton* dispute are discussed under the section addressing price suppression/depression.[1121]

[1112] Panel Report, *Korea – Commercial Vessels*, paras 7.552-7.603.
[1113] Panel Report, *US – Upland Cotton*, footnote 1503.
[1114] The Panel in *Korea – Commercial* emphasized that the serious prejudice category has to do with the negative effects on *trade interests* of other WTO Members rather than with the condition of their domestic industry (as under the injury to domestic injury standard). Panel Report, *Korea – Commercial Vessels*, paras 7.578-7.579.
[1115] Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, paras 10.18, 10.265.
[1116] See below Part II, Chapter 5, Section 5.2.2.3.
[1117] Appellate Body Report, *US – Upland Cotton*, para 431.
[1118] To be precise, the Appellate Body has made this observation with regard to Article 6.3(c) but it seems equally applicable to the other items of Article 6.3.
[1119] Appellate Body Report, *US – Upland Cotton*, para 436; Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 368.
[1120] The Appellate Body agreed with both approaches for the analysis of price suppression (Article 6.3(c) of the SCM Agreement). See Appellate Body Report, *US – Upland Cotton*, paras 436-458; Appellate Body, *US – Upland Cotton (Article 21.5)*, paras 368-370.
[1121] See below Part II, Chapter 4, Section 4.2.3.3.2.

Instead of actual 'serious prejudice', a complaining Member could show a 'threat of serious prejudice'.[1122] Indeed, the Panel in *US – Upland Cotton* confirmed that such a threat of serious prejudice suffices to trigger the remedies available in Article 7 of the SCM Agreement.[1123] At the same time, the Appellate Body emphasized that such a claim may relate to a different situation than a claim of serious prejudice: 'a claim of *present* serious prejudice relates to the existence of prejudice in the past, and present, and that may continue in the future. By contrast, a claim of *threat* of serious prejudice relates to prejudice that does not yet exist, but is *imminent such that it will materialize in the near future*'.[1124] Therefore, the Appellate Body concluded that 'a threat of serious prejudice claim does not necessarily capture and provide a remedy with respect to the same scenario as a claim of present serious prejudice'.[1125]

4.2.3.1. The origin and likeness of products under a serious prejudice claim

Before discussing the specific types of serious prejudice, the following horizontal question has to be addressed: to which products should serious prejudice be caused? The origin and likeness of products under a serious prejudice claim should be clarified.

First, regarding the origin of products, the Panel in *Indonesia – Autos* stressed that a WTO Member cannot bring a claim that another WTO Member has suffered serious prejudice. Hence, products not originating in a complaining Member country cannot be the object of a claim of serious prejudice. For instance, products made by a US *company* at its foreign plant cannot give rise to a US claim of serious prejudice. Instead, serious prejudice must occur to *products* made within the territory of the complaining party.[1126] After all, the Panel saw nothing in Article XVI GATT or Part III of the SCM Agreement that:

> (…) would suggest that the United States may claim that it has suffered adverse effects merely because it believes that the interests of US *companies* have been harmed where US *products* are not involved.[1127]

Similarly, the Panel in *US – Upland Cotton* found that allegations of serious prejudice upon other WTO Members may be taken into account 'to the extent these constitute evidentiary support of the effect of the subsidy borne by *(the complaining Member)*' but that it could not

[1122] See footnote 13 of the SCM Agreement.
[1123] See Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, paras 7.1494-7.1497.
[1124] Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 244 (emphasis *in fine* added).
[1125] Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 244.
[1126] Panel Report, *Indonesia – Autos*, paras 14.201–14.202.
[1127] Panel Report, *Indonesia – Autos*, para 14.201 (emphasis in the original).

base its decision 'on any alleged serious prejudice caused to' the other WTO Members.[1128] A complaining Member can thus only challenge serious prejudice caused to products originating in its territory. If this claim is successful, the implementation standard could imply that adverse effects to other WTO Members will be removed too.[1129] Obviously, as Article 6.3 plainly shows, such serious prejudice to products originating in the complaining Member's country could very well occur in the subsidizing or third country markets. Because these countries might be reluctant to provide relevant information, the SCM Agreement spells out a specific procedure to gather such information (Annex V), which is discussed in more detail below.[1130]

Second, regarding the scope of products in a serious prejudice claim, it is explicitly stipulated for some types of serious prejudice that their effect should be caused to '*a like product'* [Articles 6.3(a), 6.3(b), and 6.3(c)].[1131] Concerning the substance of this like product test resting upon the shoulders of the complaining party, footnote 46 SCM Agreement[1132] reveals that the term 'like product' should throughout the SCM Agreement be understood narrowly as 'identical, i.e. alike in all respects' or, at least, as having 'characteristics closely resembling' the product under consideration. In the only report so far confronted with this definition,[1133] the Panel in *Indonesia – Autos* held that the term 'characteristics *closely* resembling' is 'on its face (…) quite narrow' and 'includes but is not limited to physical characteristics'.[1134] Nonetheless, physical characteristics were considered an important element especially because other criteria (e.g., end-use, consumer perception, substitutability, price, tariff classification) were viewed by the Panel as primarily based on physical characteristics. Therefore, the Panel in *Korea – Commercial* summarized that the Panel in *Indonesia – Autos* had found that the term 'characteristics closely resembling' should 'be based principally on physical characteristics of the product',[1135] but this might somewhat overstate the Panel's

1128 Panel Report, *US – Upland Cotton,* paras 7.1414–7.1415.
1129 See Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, paras 4.80-4.92. See below Part II, Chapter 5, Section 5.1.3.2.
1130 See below Part II, Chapter 5, Section 5.1.2.
1131 Emphasis added.
1132 Footnote 46 to Article 15.1 of the SCM Agreement provides a similar definition of 'like product' as Article 2.6 of the Anti-Dumping Agreement.
1133 Noteworthy, the Panel was surprised to be the first panel confronted with this definition given that it was already inscribed in the Kennedy Round Anti-Dumping Agreement and later in the Tokyo Round Anti-Dumping and Subsidies Code and 'that investigating authorities in anti-dumping and countervailing duty cases have been wrestling with the concept of "like product" for decades'. See Panel Report, *Indonesia – Autos*, para 14.171.
1134 See Panel Report, *Indonesia – Autos*, para 14.173.
1135 Panel Report, *Korea – Commercial Vessels*, footnote 289.

emphasis on physical characteristics.[1136] In dismissing the EC's argument that *all* passenger cars are 'like' the Indonesian subsidized car 'Timor', the Panel in *Indonesia – Autos* had observed that:

> It is evident that the differences, *both physical and non-physical*, between a Rolls Royce and a Timor are enormous, and that the *degree of substitutability* between them is very low. Viewed from the perspective of the SCM Agreement, it is almost inconceivable that a subsidy for Timors could displace or impede imports of Rolls Royces, or that any meaningful analysis of price undercutting could be performed between these two models. In short, we do not consider that a Rolls Royce can reasonably be considered to have "characteristics closely resembling" those of the Timor.[1137]

With respect to the likeness test, the Panel finally agreed to use a market segmentation analysis adopted by the automotive industry itself. This analysis was designed to identify sets of products which car consumers recognize as falling within competing categories and which classified cars on the basis of a combination of size and price/market position.[1138]

Not all types of serious prejudice should explicitly pass this likeness test, however. The Panel in *Korea – Commercial Vessels* concluded that this is only required regarding those types of serious prejudice in which an explicit reference is made to 'a like product' [i.e., Article 6.3(a), Article 6.3(b), and price undercutting under Article 6.3(c) of the SCM Agreement]. Given the absence of such reference, no like product test should therefore be conducted when, for instance, price suppression/depression under Article 6.3(c) is invoked.[1139] Here, the Panel viewed 'the product issue ultimately as pertaining to the demonstration of causation, on the basis of such facts as may be relevant to the particular case'.[1140] In theory, a complainant could thus attempt to demonstrate that subsidized products cause price depression/suppression to downstream products or even to totally unrelated products but the causality test will be much more difficult, or even impossible, to pass.[1141] To pass the causality test, complainants might well be advised to confine the product category as much as possible to the products for which subsidization has been demonstrated (or even to those products for which the highest levels of subsidies have been demonstrated) as this narrows the relevant market and thus

[1136] For instance, completely-knocked down (CKD) kits were considered 'like' to completely finished products because of similar end-use and tariff classification and identical components. Observe also that the Panel considered it relevant that the prefix 'physical' characteristics in one of the draft texts was finally deleted in the final Kennedy Round Anti-Dumping Agreement (see above n 1133). See Panel Report, *Indonesia – Autos*, paras 14.173 (footnote 730), 14.196-14.197.

[1137] See Panel Report, *Indonesia – Autos*, para 14.175 (emphasis added).

[1138] All types of cars in the same segment as the Timor were thus considered like. Panel Report, *Indonesia – Autos*, para 14.178.

[1139] Panel Report, *Korea – Commercial Vessels*, para 7.553. The Appellate Body has not yet revealed whether it would share the same view. Appellate Body Report, *US – Upland Cotton*, footnote 453.

[1140] Panel Report, *Korea – Commercial Vessels*, paras 7.559, 7.600.

[1141] See Panel Report, *Korea – Commercial Vessels*, para 7.600, footnote 296. Apparently, according to this Panel, the fact that price suppression/depression should occur 'in the same market' would not preclude the demonstration of price suppression/depression to unrelated products.

increases the likelihood that the challenged subsidies have caused the alleged trade effects in this market.[1142]

The necessity to effectively demonstrate trade effects under the actionable subsidy category forms the essential difference with the prohibited subsidy category. Under the latter category, any subsidy is prohibited, regardless whether it is sufficiently large to cause trade distortion. Yet, under the actionable subsidy category, challenging subsidies in a limited number of transactions is much more complicated as it has to be established that these subsidies are sufficiently large collectively to cause the required level of trade effects in the market of the product in question (i.e., on price or volume).[1143] In *Korea – Commercial Vessels*, for instance, the Panel had concurred that subsidies in a limited number of transactions could affect the price in those transactions but it found no evidence that the aggregate effect of the subsidized transactions caused trade effects (i.e., significant price suppression) for the entire product category.[1144] Although the EC had thus successfully demonstrated the existence of specific subsidies under Articles 1 and 2 of the SCM Agreement, its actionable subsidy claim was rejected because it had failed to demonstrate trade effects for the entire product category.[1145] In the following sections, the specific types of trade effects spelled out under the serious prejudice category are scrutinized (Article 6.3 of the SCM Agreement). A distinction is made between volume and price effects.

4.2.3.2. Volume effects

4.2.3.2.1. Impediment or displacement of trade to the market of the subsidizing Member or a third country

Article 6.3(a) of the SCM Agreement implies that, even in the absence of any prior tariff commitment, WTO Members could cause adverse effects through subsidization if such

[1142] See below n 1144.
[1143] Serious prejudice in the meaning of significant 'lost sales' under Article 6.3(c) might be seen as partly circumventing this difficulty but its scope is not clarified so far. For unclear reasons, the EC in *Korea – Commercial Vessels* did not formulate an alternative claim on the basis of 'lost sales' (see below n 1168).
[1144] Panel Report, *Korea – Commercial Vessels*, paras 7.676-7.690. The EC had separately formulated its serious prejudice claim in respect of different ship categories. Hence, the Panel examined whether individual subsidized transactions in each category caused significant price suppression in the relevant ship category. Recall that the 'like product' test does not have to be passed in case of a 'price suppression' claim. The EC was thus free to separate trade effects in different ship categories. In doing so, the number of subsidized transactions which could be taken into account in each category diminished but the scope of each relevant market was likewise reduced.
[1145] For instance, the Panel concluded that '(w)hile we certainly accept the possibility that the subsidized financing affected the prices in the individual transactions, we find nothing in the evidence and arguments before us demonstrating that the aggregate effect of the subsidized transactions is significant price suppression for the entire product category of product/chemical tankers'. Panel Report, *Korea – Commercial Vessels*, para 7.688.

subsidization has the effect 'to displace or impede the imports of another Member into *the market of the subsidizing country*'.[1146] In addition to Article 5(b) of the SCM Agreement (nullification or impairment), it thus further opens the door to address injury caused by subsidization in the subsidizing country's domestic market. In turn, Article 6.3(b) of the SCM Agreement addresses a similar situation in which the effect of subsidization results in displacement or impeding of exports from a *third country market*.

The Panel in *Indonesia – Autos* explained that '*displacement* relates to a situation where sales volume has declined, while *impedance* relates to a situation where sales which otherwise would have occurred were impeded'.[1147] Importantly, these volume effects identified under Article 6.3 (a) and (b) of the SCM Agreement should not be 'significant' in order for 'serious prejudice' to be present. This stands in contrast with the potential effect on prices (under Article 6.3(c) of the SCM Agreement) caused by subsidization as only *significant* price effects are according to the text considered to amount to serious prejudice.

Could the elements of 'displacement' or 'impediment' under Article 6.3 (a) and (b) be properly separated from the causation element ('effect of the subsidy')? As the Appellate Body in *US – Upland Cotton* has explained, 'it might be difficult to ascertain whether imports or exports are "displace[d]" or "impede[d]" under paragraphs (a) or (b) of Article 6.3 of the *SCM Agreement* without considering the effect of the challenged subsidy'.[1148] Indeed, the ordinary meaning of the verbs 'impede' and 'displace' seems to imply the existence of a subject (the challenged subsidies) and an object (in this case, imports or exports in the subsidizing and third country markets, respectively).[1149] Contrary to the Appellate Body's statement, the SCM Agreement, however, allows that, with respect of Article 6.3(b) of the SCM Agreement, displacement or impediment might be demonstrated without taking into consideration the effect of the subsidy. This follows from the operation of Article 6.4 of the SCM Agreement, which is discussed next.

4.2.3.2.1.1. Impediment or displacement of trade to third country markets

Article 6.3(b), dealing with subsidy effects on trading partners' exports to third country markets, should be read together with Article 6.4 of the SCM Agreement. This provision

[1146] Article 6.3(a) of the SCM Agreement (emphasis added). See also Hoda and Ahuja, above n 1088, at 1020.
[1147] Panel Report, *Indonesia – Autos*, para 14.218 (emphasis added).
[1148] Appellate Body Report, *US – Upland Cotton*, para 433, footnote 521.
[1149] This paraphrases the Appellate Body's reasoning in *US – Upland Cotton* with regard to price suppression. Appellate Body Report, *US – Upland Cotton*, para 433.

stipulates that, for the purpose of Article 6.3(b) – and thus *not* for the purpose of Article 6.3(a)[1150] – 'displacement or impeding of exports shall include any case in which (…) it has been demonstrated that there has been a change in relative shares of the market to the disadvantage of the non-subsidized like product'. This should be assessed 'over an appropriately representative period sufficient to demonstrate clear trends in the development of the market for the product concerned, which, in normal circumstances, shall be at least one year'.[1151] On substance, such 'change in relative shares of the market' includes any of the three following situations: '(a) there is an *increase* in the market share of the subsidized product; (b) the market share of the subsidized product remains *constant* in circumstances in which, in the absence of the subsidy, it would have declined; (c) the market share of the subsidized product *declines*, but at a slower rate than would have been the case in the absence of the subsidy'.[1152] Hence, not only subsidies causing the expansion of market share but also those keeping market shares constant or slowing their decline could be challenged. Under *items (b) and (c)* of Article 6.4 of the SCM Agreement, the effect of the subsidy is taken on board as it calls for a comparison of the evolution in actual market share of the subsidized product with the counterfactual situation ('but for' the subsidy). Under these two items, a unitary approach seems to be implied given that the causation element (effect of the subsidy) is already presupposed in the identification of 'displacement' and 'impeding'. The text itself seems to point to a 'but for'-approach: a comparison should be made between the actual market share evolutions with the counterfactual situation where no subsidy would have been offered. On the other hand, and somewhat counterintuitive, an *increase* in the market share of the subsidized product (*item (a)*) seems sufficient to establish displacement/impediment regardless whether such increase is the effect of the subsidy. In this case, a bifurcated approach thus seems to be called for. The question whether the increase is the effect of the subsidy is analyzed separately. Significantly, according to the Panel in *Indonesia – Autos*, the burden of proof regarding this second layer (i.e., effect of the subsidy) does not seem to rest on the complainant's shoulders since a *prima facie* case of displacement or impediment would 'arguably' be made 'simply by demonstrating that the market share of a subsidized product has increased over an appropriately representative period'.[1153] This interpretation would mean that, contrary to claims under all other items of Article 6.3 (and 6.4[1154]) of the SCM

[1150] Panel Report, *Indonesia – Autos*, para 14.210
[1151] Article 6.4 of the SCM Agreement.
[1152] Emphasis added.
[1153] Panel Report, *Indonesia – Autos*, paras 14.209, 14.215. See also R. H. Steinberg and T. E. Josling, 'When the Peace Ends: the Vulnerability of EC and US Agricultural Subsidies to WTO Legal Challenge', 6:2 *Journal of International Economic Law* (2003), 369-417, at 387.
[1154] In its statement, the Panel refers to Article 6.4 of the SCM Agreement *as such* and not to Article 6.4(a) in particular. However, its example refers to the situation elaborated in Article 6.4(a) (i.e., increase in market share). Moreover, as elaborated above, the text of items (b) and (c) as well as the

Agreement, a *prima facie* case of a claim under Article 6.3(b) *juncto* 6.4(a) of the SCM Agreement could be made by the complainant without having to establish that the effect on the market is caused by subsidization.[1155]

4.2.3.2.1.2. Impediment or displacement of trade to the market of the subsidizing country

The complainants in *Indonesia – Autos* could not rely upon Article 6.4 because their claim was based on Article 6.3(a). They argued that subsidies granted to the Indonesian automotive industry impeded or displaced their imports of autos into the Indonesian market. Hence, they had to demonstrate that the effect of the subsidy was displacement or impediment: i.e., 'that some imports that would have occurred did not occur as a result of the subsidies'.[1156] Analyzing whether sales of like products of the complainants would have been higher in the subsidizing country 'but for' the subsidy,[1157] the Panel concluded that both the EC and US failed to advance sufficient evidence to underpin their claim.[1158] A declining market share was considered highly relevant but not decisive to show that 'but for' the subsidies sales would have been higher in *absolute* terms.[1159] 'In the usual case', the Panel agreed that 'a decline in market share in a stable or growing market, corresponding in time with the introduction of a subsidized product, might suggest that sales would have been higher but for the introduction of the subsidized product'.[1160] Yet, because Indonesia made a convincing argument that the subsidy itself could have caused a rapid expansion of the market, leading to a higher market share for the subsidized domestic product (and thus lower market share for EC products), even a dramatic drop in the EC's market share was considered insufficient to demonstrate that it also lost sales in *absolute* terms.[1161] In sum, the Panel in *Indonesia – Autos* decided that impediment or displacement in the *subsidizing market* is only present under Article 6.3(a) if complainants' sales in *absolute* terms would have been higher in the absence of the subsidies, even though a relative loss might be relevant to show an absolute loss. In contrast, by virtue of Article 6.3(b) *juncto* 6.4 of the SCM Agreement, a *prima facie*

Appellate Body's statement in *US – Upland Cotton* clearly show that the phrase 'effect of the subsidy' by definition calls for a unitary approach. Therefore, if one would accept the Panel's reasoning, this should be confined to Article 6.4(a) of the SCM Agreement.

[1155] Indeed, this could also *a contrario* be derived from the Panel's observation that in case the analysis of Article 6.4 is *not* applicable, 'complainants must demonstrate that "*the effect of the subsidy* " is to displace or impede imports'. Panel Report, *Indonesia – Autos*, paras 14.209, 14.215 (emphasis in the original).

[1156] A declining market share may be relevant but is not decisive. Panel Report, *Indonesia – Autos*, paras 14.209, 14.215

[1157] Panel Report, *Indonesia – Autos*, para 14.218

[1158] Panel Report, *Indonesia – Autos*, paras 14.222, 14.229, 14.235, 14.236

[1159] Panel Report, *Indonesia – Autos*, para 14.211.

[1160] Panel Report, *Indonesia – Autos*, para 14.219.

[1161] Panel Report, *Indonesia – Autos*, para 14.222. Only the EC's claim with regard to price undercutting was accepted (see below Part II, Chapter 4, Section 4.2.3.3.1).

case of displacement or impediment in *third country markets* would be established if complainants would have lost sales in *relative* terms (i.e., market share) as a result of the subsidy to domestic producers.[1162] This conclusion illustrates an important difference between Article 6.3(a) and 6.3(b) of the SCM Agreement as interpreted in the case law.

4.2.3.2.1.3. Circumstances in which no displacement or impediment of trade would arise

A number of situations are listed in Article 6.7 of the SCM Agreement in which serious prejudice in the form of displacement or impediment under both Article 6.3(a) and (b) shall not be considered to arise.[1163] These are, according to the Panel in *Korea – Commercial Vessels*, 'concerned with alternative reasons (including, for example, prohibition or restriction on exports, and situations of *force majeure* affecting production, qualities, quantities or prices of the product available for export) for declines in the overall volume and/or market share of the complaining Member'.[1164] Hence, this provision would somewhat resemble the non-attribution requirement in CVDs procedures.[1165] A decline in volume or market share should not be attributed to subsidization if it is caused by one of the six listed alternative reasons.[1166] But contrary to the CVDs context, the complaining Member seems not required to demonstrate that these alternatives are not present. According to the Panel in *US – Upland Cotton*, this provision '*allows a subsidizing Member to raise a defence* to a displacement/impedance claim where "imports from the complaining Member" or "exports from the complaining Member" are affected by such factors (…)'.[1167]

[1162] The Panel reasoned that:

> 'If Article 6.4 of the SCM Agreement applied in this dispute, this showing of a change in relative market shares to the disadvantage of the non-subsidized like product might well have been sufficient to establish the European Communities' *prima facie* case of displacement or impedance. In the absence of that article, however, it is not enough for the European Communities to demonstrate a decline in relative market share; rather, the European Communities must demonstrate that (…) some imports that would have occurred did not occur as a result of the subsidies. While declining market share may be relevant to establishing such a situation, we consider that we must proceed further with the analysis and look at actual sales figures for the products in question'.

Panel Report, *Indonesia – Autos*, para 14.215.

[1163] This seems to indicate that 'displacement or impediment' does not *exist* if it is not the effect of the subsidy but of something else.

[1164] Panel Report, *Korea – Commercial Vessels*, para 7.586.

[1165] See below Part II, Chapter 5, Section 5.2.2.3.

[1166] Remarkably, the text of Article 6.5 of the SCM Agreement simply stipulates that 'displacement or impediment resulting in serious prejudice shall *not arise* (…) where any of the following circumstances *exist* during the relevant period' (emphasis added). On its face, the simple *existence* of one of the listed circumstances (and thus not even that it has caused the volume or market share effect) would thus be sufficient for dismissing serious prejudice even if subsidization could be a necessary and/or sufficient condition to cause the mandated level of decline in market shares or volume.

[1167] Panel Report, *US – Upland Cotton*, footnote 1503 (emphasis added). See also Steinberg and Josling, above n 1153, at 410.

4.2.3.2.2. Significant lost sales in the same market

One of the elements listed under Article 6.3(c) of the SCM Agreement refers to a volume effect. Serious prejudice would arise if the subsidy leads to significant 'lost sales in the same market'. The scope of this form of serious prejudice has not yet been clarified in the case law.[1168,1169] The ordinary meaning of '*lost* sales' in conjunction with the causality test ('effect of the subsidy') seems to call for the rather demanding demonstration that producers originating in the complaining Member would have acquired those sales 'but for' the subsidies.[1170] Moreover, the loss in sales should be 'significant', which has been interpreted in a broad manner in the context of other items of Article 6.3(c) as 'important, notable or consequential'. The concept of 'the same market' is also given an expansive meaning under Article 6.3(c) given that the case law did not read any geographical restriction in this phrase. Hence, this could refer not only to national markets but also to the world market as a whole.

4.2.3.2.3. Increase in the world market share of primary product or commodity

Article 6.4(d) of the SCM Agreement addresses a situation whereby subsidies to a primary product or commodity have the effect of 'an increase in the world market share of the subsidizing Member'. The scope of this provision is thus explicitly confined to subsidies to primary products or commodities.[1171] The increase in the world market share should be the 'effect of the subsidy'. The Appellate Body in *US – Upland Cotton* acknowledged that this causality requirement could be determined separately from the assessment whether an increase had effectively occurred (i.e., bifurcated test).[1172] The interpretation of this causality requirement is clarified in the case law discussed below under the section on price suppression/depression.[1173]

[1168] In *Korea – Commercial Vessels*, the EC provided examples of sales that it alleged were lost to Korean shipyards. Yet, the EC did not formulate a claim of lost sales but advanced these examples in the context of its price suppression claim. See Panel Report, *Korea – Commercial Vessels*, para 7.664.
[1169] The causality requirement (i.e., 'effect of the subsidy') is also clarified in the context of the other items of Article 6.3(c) (see below Part II, Chapter 4, Section 4.2.3.3.2).
[1170] Note that in the context of CVDs investigations, one of the elements that should be examined is the effect of the subsidized imports on the decline in sales of the domestic industry (Article 15.4 of the SCM Agreement).
[1171] Footnote 17 indicates that Article 6.4(d) applies '(u)nless other multilaterally agreed specific rules apply to the trade in the product or commodity in question'. Both parties in *US – Upland Cotton* seemed to agree that this does certainly not refer to the Agreement on Agriculture. See also Panel Report, *US – Upland Cotton*, footnote 1508. For the definition of 'primary product', inspiration might be found in Ad Article XVI, Section B, para 2 of GATT 1994.
[1172] Appellate Body Report, *US – Upland Cotton*, footnote 521. See also Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, paras 10.263-10.264.
[1173] See below Part II, Chapter 4, Section 4.2.3.3.2.

Regarding the increase in the world market share, two elements have to be established.[1174] The subsidizing Member's share should have increased compared to its average share 'during the previous period of three years' and this increase should follow 'a consistent trend over a period when subsidies have been granted'. This increase has to be observed in 'the world market', which, according to the Panel in *US – Upland Cotton*, refers to the subsidizing Member's share in world *production* and not to its share in world *exports*. This implies that the portion of subsidized products not exported is also taken into consideration.[1175,1176] In sum, Article 6.4(d) 'calls for an examination of the portion of the world's supply that is satisfied by the subsidizing Member's producers'.[1177] In the compliance procedure, the Panel rejected Brazil's claim under Article 6.4(d) because the data did not reveal an increase in the US share of world production (FY 2006) as compared to the average US share in the previous three years (FY 2002-2005).[1178]

These demanding conditions to show an increase in the subsidizing Member's world market share clearly limit the usefulness of this type of serious prejudice. For instance, a subsidy programme boosting the subsidizing Member's world market share at the time of introduction and *sustaining* this market share in subsequent years would not seem to violate Article 6.3(d).[1179] Generally speaking, only subsidy programmes increasing a Member's share in world production year by year would be captured under Article 6.4(d). In challenging subsidy programmes to primary products or commodities, complaining Members might therefore more easily achieve success in their claims formulated under other types of serious prejudice spelled out in Article 6.3.[1180]

[1174] Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 10.261.
[1175] Because it was based on an alleged increase in the US share in *exports* for cotton, Brazil's claim under Article 6.4(d) failed. The Appellate Body exercised judicial economy on Brazil's appeal regarding the Panel's interpretation of Article 6.4(d). See Appellate Body Report, *US – Upland Cotton*, para 507.
[1176] The Panel defined 'world market share' as 'the share of the world market supplied by the subsidizing Member' (para 7.1463). The Panel thus also rejected the US interpretation that the 'world market share' should be defined by reference to consumption (i.e., the portion of world consumption of US cotton satisfied by US upland cotton). Panel Report, *US – Upland Cotton*, paras 7.1424-7.1464.
[1177] Panel Report, *US – Upland Cotton*, para 7.1434.
[1178] Panel Report, *US – Upland Cotton (Article 21.5 – Brazil*), para 10.266. This finding was not appealed. See Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil*), footnote 692.
[1179] Indeed, an increase during the most recent year should be demonstrated as compared to the average share in three previous years and this increase should follow a consistent trend over the time period of the subsidy programme. Hence, the comparison is not made with regard to the pre-subsidy period. For example, in the *US – Upland Cotton* case, the US market share in FY2006 was compared to its average market share in previous subsidized years (FY2002-FY2005).
[1180] Whereas Brazil failed to challenge the US subsidies for upland cotton under Article 6.4(d), its claim under price suppression/depression (Article 6.3(c)) was successful (see below Part II, Chapter 6, Section 6.1.2).

4.2.3.3. Price effects

4.2.3.3.1. Significant price undercutting

The first type of 'serious prejudice' related to price effects refers to significant price undercutting caused by the subsidized product as compared with the price of a like product of another Member in the same market (Article 6.3(c)). Such price undercutting could also occur in the domestic market of the subsidizing country.[1181]
Regarding the demonstration of such price undercutting, Article 6.5 clarifies that this includes any case in which it has been demonstrated 'through a comparison of prices of the subsidized product with prices of a non-subsidized like product supplied to the same market' and that such comparison 'shall be made at the same level of trade and at comparable times, due account being taken of any other factor affecting price comparability'.[1182] Alternatively, and only 'if such a direct comparison is not possible, the existence of price undercutting may be demonstrated on the basis of export unit values'.[1183] Similar to other items of Article 6.3(c), serious prejudice is only present if such price undercutting is 'significant'. This qualifier was, according to the Panel in *Indonesia-Autos*, 'presumably (…) intended to ensure that margins of undercutting so small that they could not meaningfully affect suppliers of the imported product whose price was being undercut are not considered to give rise to serious prejudice'.[1184] In the Panel's reading in *Korea – Commercial Vessel*, this means that 'the term "significant" as a *de minimis* concept intended to screen out very small, unimportant price effects that might be caused by subsidies but that would have no real impact in the market'.[1185] Apparently, one can identify a tendency in the case law to not put the burden for passing the 'significance' test too high.

In examining the presence of such price undercutting, the Panel in *Indonesia – Autos* found that the price difference between the EC's imported cars and domestic like cars was significant even when differences in quality were taken into account.[1186,1187] Because

[1181] See Panel Report, *Indonesia – Autos*, paras 14.241-14.256
[1182] For example, the Panel in *Indonesia – Autos* observed that transaction prices of complety-knocked down (CKD) cars and retail prices of completely finished cars would presumably not be 'at the same level of trade'. Panel Report, *Indonesia – Autos*, para 14.244.
[1183] Article 6.5 of the SCM Agreement.
[1184] Panel Report, *Indonesia – Autos*, para 14.254.
[1185] According to this Panel, this low-threshold interpretation is similar to the interpretation given in the *US – Upland Cotton* case, in which the Panel referred to 'important, notable or consequential'. Panel Report, *Korea – Commercial Vessels*, paras 7.570-7.571.
[1186] Because Indonesia was considered a developing country, the preliminary analysis under Article 27.8 *juncto* 6.1 of the SCM Agreement had to be undertaken (see below Part II, Chapter 6, Section 6.1.2).
[1187] The Panel took into account differences in physical characteristics (e.g., size, engine, tyre, safety features (ABS, airbags), and extra features (e.g., alarm system)) because '(w)hile these differences are

Indonesia conceded that its subsidies were responsible for the significant price undercutting as compared to EC's imported like cars, the Panel concluded that Indonesia's car subsidy programme caused 'serious prejudice' in the sense of Article 5(c) of the SCM Agreement.

4.2.3.3.2. Significant price suppression or depression

The case law has revealed that *price suppression* occurs when 'prices (…) either are prevented or inhibited from rising (i.e., they do not increase when they otherwise would have) or they do actually increase, but the increase is less than it otherwise would have been'.[1188] *Price depression*, on the other hand, covers 'the situation where prices are pressed down, or reduced'.[1189] The comparison has to be made with the price of products 'in the same market', which could be defined either narrowly or broadly (e.g., world market) depending on the facts of the case.[1190]

The Appellate Body acknowledged that situations of price suppression and depression could overlap but emphasized that both concepts are distinct, also on a conceptual level. It correctly reasoned in *US – Upland Cotton (Article 21.5 – Brazil)* that price suppression 'presupposes a comparison of an observable factual situation (prices) with a *counterfactual situation* (what prices would have been) where one has to determine whether, in the absence of the subsidies (or some other controlling phenomenon), prices would have increased or would have increased more than they actually did'.[1191] Price depression, by contrast, does no presuppose such comparison as it could be 'directly observed, in that falling prices are observable'.[1192] To be sure, also in case of price depression, comparison with a counterfactual situation will be required to establish the causation element: 'the determination of whether such falling prices are the effect of the subsidies will require consideration of what prices would have been

not sufficient to render the three models unlike, they must clearly affect price comparability to some extent'. On the other hand, the Panel found no significant non-physical characteristics (e.g., brand image) for which due allowance had to be made. Panel Report, *Indonesia – Autos*, paras 14.246, 14.253.

[1188] The term price covers 'the amount of money set for sale' of the product in question or the 'value or worth' of that product. Panel Report, *US – Upland Cotton*, para 7.1277 and footnote 1388; Appellate Body Report, *US – Upland Cotton*, para 423; Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil*), para 350.

[1189] Panel Report, *US – Upland Cotton*, para 7.1277 and footnote 1388; Appellate Body Report, *US – Upland Cotton*, para 423; Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil*), para 350.

[1190] See, for example, Panel Report, *Korea – Commercial Vessels*, paras 7.565, 7.566.

[1191] Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 351 (emphasis added).

[1192] Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 351. This seems to differ from the Panel's holding in *Korea – Commercial Vessels* that the counterfactual situation should be analyzed also for the identification of 'price depression'. Panel Report, *Korea – Commercial Vessels*, para 7.537.

absent the subsidies'.[1193] Indeed, 'counterfactual analysis is *an inescapable part* of analysing the effect of a subsidy under Article 6.3(c) of the SCM Agreement'.[1194]

Although it had allowed a bifurcated approach,[1195] the Appellate Body in the *US – Upland Cotton* compliance procedure endorsed the Panel's unitary approach to decide on the claim of price suppression. Here, no distinction was made between the assessment of price suppression and causation.[1196] Such a unitary approach seems to fit to the Appellate Body's reasoning that the determination of price suppression is indeed counterfactual in nature.[1197] The Appellate Body also concurred that this counterfactual nature calls for a 'but for' test.[1198] Indeed, 'the Panel had to determine whether the world price of upland cotton would have been higher in the absence of the subsidies (that is, *but for* the subsidies)'.[1199] Even though the Panel had conducted such an analysis, the Appellate Body criticized that it did not clearly articulate the causation standard implicated in its approach.[1200] In particular, the question was addressed to what extent the Panel's 'but for' test effectively filtered out other factors that could have attributed to price suppression. In this respect, the Appellate Body elaborated upon the causation standard:

> A subsidy may be necessary, but not sufficient, to bring about price suppression. Understood in this way, the "but for" test may be too undemanding. By contrast, the "but for" test would be too rigorous if it required the subsidy to be the only cause of the price suppression. Instead, the "but for" test should determine that price suppression is the effect of the subsidy and that there is a "genuine and substantial relationship of cause and effect".[1201]

This statement reveals in a rather cryptic way some elements of the required causal link between the subsidy and price suppression. A necessary condition (*sine qua non*) seems not sufficient, but the 'only cause' seems not necessary. Instead, the Appellate Body reiterated the causation standard which it had articulated in the context of other WTO Agreements, namely the general (and vague) standard of a 'genuine and substantial relationship of cause

[1193] Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 351.
[1194] Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 351 (emphasis added).
[1195] The original Panel and Appellate Body reports were criticized by Sapir and Trachtman for confusing price suppression and price reduction since they conducted a bifurcated test for price suppression. See A. Sapir and J. Trachtman, 'Subsidization, Price Suppression, and Expertise: Causation and Precision in Upland Cotton', 7:1 *World Trade Review* (2008), 183-209.
[1196] The same unitary approach was adopted by the Panel in *Korea – Commercial Vessels*, para 7.612.
[1197] Indeed, the Appellate Body observed that '(b)ecause of the counterfactual nature of price suppression, it is difficult to separate price suppression from its causes. Hence, the Panel's "unitary" analysis", (…), has a sound conceptual foundation'. Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 354. See also Sapir and Trachtman, above n 1195, at 183-209.
[1198] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, paras 370-371; Panel Report, *US – Upland Cotton (Brazil – Article 21.5)*, paras 10.46-10.48; Panel Report, *Korea – Commercial Vessels*, paras 7.537-7.612.
[1199] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 370.
[1200] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 374.
[1201] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 374.

and effect'.[1202] This implies that panels should ensure that the effects of other factors on the price do not dilute such 'genuine and substantial link'. At the same time, panels are given some discretion in choosing the methodology to make this assessment.[1203]

Importantly, Article 6.3(c) stipulates that the degree of price suppression or depression should be significant, which the Appellate Body has, in line with the Panel in *US – Upland Cotton*, understood as 'important, notable or consequential'.[1204,1205] Obviously, 'what needs to be significant is the degree of price suppression *(or depression)*, not necessarily the degree of each factor used as an indicator for establishing its existence'.[1206] Moreover, the Panel in *US – Upland Cotton (Brazil – Article 21.5)* agreed with the original panel that this degree of significance may 'vary from case to case, depending upon the factual circumstances'.[1207] With regard to the upland cotton market, for instance, the required degree of significance was not set too high because:

> (…) for a basic and widely traded commodity, such as upland cotton, a relatively small decrease or suppression of prices could be significant because, for example, *profit margins* may ordinarily be narrow, *product homogeneity* means that sales are price sensitive or because of the *sheer size of the market* in terms of the amount of revenue involved in large volumes traded on the markets experiencing the price suppression.[1208]

In sum, the Panel in *US – Upland Cotton (Brazil – Article 21.5)* assessed whether, but for the cotton subsidies, the world market price for upland cotton would have increased significantly,

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[1202] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 374 (see also para 372); Appellate Body Report, *US – Upland Cotton*, para 438; Appellate Body Report, *US – Wheat Gluten*, para 69.

[1203] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, paras 370, 375; Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, paras 376-379. See below Part II, Chapter 4, Section 4.2.3.3.2.4.

[1204] Appellate Body Report, *US – Upland Cotton*, para 426; Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 416; Panel Report, *US – Upland Cotton*, paras 7.1326-7.1328; Panel Report, *Korea – Commercial Vessels*, para 7.570.

[1205] One might wonder whether subsidies should be sufficient on their own (*sufficient condition*) to cause *significant* price suppression/depression. In the context of the Safeguards Agreement, in which the 'genuine and substantial link' standard was developed, the Appellate Body decided that the causation standard does not require that 'increased imports *on their own* must be capable of causing serious injury' (Appellate Body Report, *US – Wheat Gluten*, paras 67-70 (emphasis in the original)). Nonetheless, panels and the Appellate Body in *US – Upland Cotton* correctly seem to hold that the relevant question under Article 6.3(c) is whether the subsidies on their own were sufficient to *significantly* suppress prices. See, for example, Panel Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 10.49; Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, paras 360-366.

[1206] The Appellate Body continued that each factor does not 'necessarily have to be capable of demonstrating, to the same extent, significant price suppression'. Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 416 (emphasis added).

[1207] Panel Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 10.50.

[1208] Panel Report, *US – Upland Cotton*, paras 7.1328-7.1329 (emphasis added). This is also cited by the Panel Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 10.50.

or would have increased by significantly more than was in fact the case.[1209] As the Appellate Body explained, such price suppressing effect would result from additional, 'marginal', production induced by subsidization.[1210] To conduct the 'but for' analysis, capturing simultaneously the price suppression and causal relationship elements, a number of different relevant factors were considered collectively. First, a group of factors revealed whether it was likely that the subsidy, through creating marginal production, could have a significant price suppressing effect. Second, trend analysis was used to detect if there was a correlation between subsidy levels and price evolutions. Third and finally, economic modeling (i.e., quantitative analysis) was suggested so as to effectively estimate if prices were suppressed as a result of subsidization. Several economists have rightly argued that the causality requirement in Article 6.3(c) cannot be established without such quantitative analysis. These three elements discussed in the *US – Upland Cotton* compliance procedure are elaborated in more detail below. This case law offers important guidance on how price suppression will have to be demonstrated in future cases.

4.2.3.3.2.1. Factors related to the subsidy and its production stimulating effect

A number of elements were advanced that made it plausible that US subsidies for upland cotton (i.e., marketing loan and countercyclical payments) could significantly suppress prices on the world market as a result of inducing additional production. First, the large US share in world production and exports of upland cotton implied that the US exerted 'a substantial proportionate influence' on the world market for upland cotton.[1211] Indeed, only subsidies by so-called 'large countries' (i.e., which affect supply and demand; Part I[1212]) could stimulate production in a way that it affects the world market price and thus cause adverse effects upon producers of other WTO Members.

Second, the nature (i.e., 'structure, design, and operation') as well as magnitude of the subsidy were also deemed relevant factors to an analysis of whether the effect of the subsidy is price suppression. The Appellate Body upheld the Panel's finding that the marketing and countercyclical payments affect US production as a result of their mandatory and price-contingent nature and their revenue-stabilizing effect.[1213] Exact quantification of the subsidy level is not required in an analysis under Article 6.3(c) but the magnitude of the subsidy level

[1209] Panel Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 10.49.
[1210] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 355.
[1211] Panel Report, *US – Upland Cotton (Brazil – Article 21.5)*, paras 10.54-10.58. Panel Report, *US – Upland Cotton*, para 7.1348.
[1212] As explained in Part I (Chapter 1, Section 1.1), the relevant question is whether the country is large in the production of the product in question.
[1213] Panel Report, *US – Upland Cotton (Brazil – Article 21.5)*, paras 10.59-10.111; Panel Report, *US – Upland Cotton*, paras 7.1289, 7.1349; Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 362.

is an important element in this analysis, though it certainly is not the only relevant one.[1214] Obviously, '(a) large subsidy that is closely linked to prices of the relevant product is likely to have a greater impact on prices than a small subsidy that is less closely linked to prices'.[1215]

Third, the significant gap between total production costs of US upland cotton producers and their market revenue suggested that the subsidies were an important factor affecting the economic viability of US cotton production.[1216] The Appellate Body agreed with the Panel that total production costs include the opportunity cost of production factors. Moreover, the calculation of production costs is based on total costs and not merely on variable costs because the time period of the subsidy programme called for a medium to long-term analysis.[1217,1218]

4.2.3.3.2.2. Trend analysis

One of the factors underpinning the original Panel's finding in *US – Upland Cotton* of a causal relationship was the 'discernible temporal coincidence' of suppressed world market prices and the price-contingent subsidies. Over the same period that the challenged subsidies were granted (1998-2002), there was a marked increase in US exports (in relative and absolute terms) and drop in the world price. The Appellate Body correctly underscored that mere correlation is not sufficient to demonstrate causation. Indeed, the price trend might very well be explained (i.e., caused) in full or part by other factors. Equating correlation to causation would lead to so-called Type II errors: accepting the hypothesis of causality when it is actually false. Nonetheless, because 'one would normally expect a discernible correlation between significantly suppressed prices and the challenged subsidies if the effect of these subsidies is significant price suppression', such trend analysis is deemed in the Appellate Body's view as an 'important factor in any analysis' of whether the effect of a subsidy is significant price suppression under Article 6.3(c) of the SCM Agreement.

On the compliance level, the Panel failed to observe a similar 'discernible temporal coincidence' between US subsidies and suppressed prices. US production and exports had

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1214 Appellate Body Report, *US – Upland Cotton*, para 461.
1215 Appellate Body Report, *US – Upland Cotton*, para 461.
1216 Panel Report, *US – Upland Cotton (Brazil – Article 21.5)*, paras 10.147-10.196; Panel Report, *US – Upland Cotton*, paras 7.1353-7.1354.
1217 Panel Report, *US – Upland Cotton (Brazil – Article 21.5)*, paras 10.167-10.176.; Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, paras 423, 427-428; Appellate Body Report, *US – Upland Cotton*, para 453. The Appellate Body also agreed that it was reasonable for the Panel to exclude off-farm income from US upland cotton producers' income. Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 431.
1218 The Appellate Body highlighted that such calculation of production costs was consistent with its approach taken in the compliance procedures in *Canada – Dairy* (see below Part II, Chapter 6, Section 6.2.1.2.1.1.2). Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, paras 423, 427-428. Appellate Body Report, *Canada – Dairy (Article 21.5 – US and New Zealand)*, para 87; Appellate Body Report, *Canada – Dairy (Article 21.5 – US and New Zealand II)*, paras 102-104.

increased over the relevant period (i.e., 2002-2005 period) but only in absolute not in relative terms and no broad decline in cotton prices but merely 'intermittent peaks and troughs' could be detected.[1219] Nonetheless, the Panel rightly concluded that the absence of a general decline in prices over this period of subsidization does not necessarily imply that there is no price suppression. Indeed, prices could still have been higher 'but for' the subsidies.[1220] Apparently, the absence of such correlation was therefore also not considered as a relevant counterargument that no price suppression existed.[1221]

The Appellate Body's observation in the original procedure that one 'would *normally* expect a discernible correlation between significantly suppressed prices and the challenged subsidies' might overlook the simple fact that price *suppression* cannot be excluded on the basis of a table showing price evolutions. Indeed, price trends give no information on whether prices would still have been higher in the absence of subsidies unless price levels could be compared before and after subsidies were introduced. Attaching too much importance to the absence of a correlation between subsidy levels and price trends would lead to so-called Type I errors: rejecting the hypothesis of causation where this should have been accepted. The compliance Panel seemed to understand this point as it apparently even considered the absence of such correlation as not relevant.

In sum, the presence of a 'discernible temporal coincidence' between a decline in world market prices and subsidies is considered a relevant though not a sufficient factor to demonstrate causation. Conversely, the absence of such a coincidence is insufficient to exclude a finding of causation and might not even be considered relevant in the overall determination thereof. In short, a (negative) correlation between subsidy and price levels is neither necessary nor sufficient to a finding of causation.

4.2.3.3.2.3. Economic modeling

Whereas all previous factors could make it plausible that the subsidy, by stimulating production, did cause significant price suppression, they do not *test* whether this effectively happened. Indeed, only economic analysis could effectively estimate the existence and degree of any price suppression *caused* by the subsidies.

One such an instrument is an economic simulation model, which was introduced by Brazil before the compliance Panel in *US – Upland Cotton* to simulate the effect of US subsidies on the world market for cotton. The model, a two-country (US and rest of the world) demand

[1219] Panel Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 10.141.
[1220] Panel Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 10.146. This was not appealed by the US.
[1221] The Panel only listed it as one of the arguments advanced by Brazil that was less persuasive. See Panel Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 10.251.

and supply log-linear displacement model, simulates a counterfactual situation: how much would world prices, and production and imports/exports in the US and the rest of the world change (in percentage) in case the subsidies would be removed?[1222] Because the Arbitrator in *US – Upland Cotton* relied upon this model to quantify the effect of a withdrawal of US subsidies, this model is explained in more detail below.[1223] Under the serious prejudice analysis of Article 6.3(c) of the SCM Agreement, Brazil advanced the model to quantify (by estimation) the price suppressing effect of the US subsidies. The US formulated a double criticism on this model before the compliance panel. First, it questioned the very structure of the model itself without, however, suggesting its own alternative model. Second, the US questioned the value of the parameters included by Brazil in its model (e.g., demand and supply elasticities) and proposed its own set of parameter values. After presenting both parties' arguments, the Panel noted 'the advantage of the modeling approach that Brazil has chosen to adopt' but, at the same time, remained 'mindful of the criticism by the United States that (it) "has no foundation within economic circles"'.[1224] Moreover, regarding the parameters included in the model, the Panel explicitly refrained from taking position on which parameter values were appropriate. The Panel simply concluded that under all simulations run by the parties (thus also with the US parameter values) price suppression was the outcome.[1225] Hence, the Appellate Body correctly analyzed that the Panel did not take a position on the appropriateness of the model and the suggested parameters. Yet, it only concluded that the Panel could therefore 'have gone further in its evaluation and comparative analysis' but decided that it did not commit an error of law.[1226] In my opinion, the Appellate Body's conclusion could have been stronger. After all, how could the model support the Panel's conclusion of price suppression without any prior determination that it is indeed based on solid economic grounds?[1227] Moreover, what about the US argument that when the simulation is run with US parameter values, a price suppression effect of approximately 1 per cent would be found (compared to approximately 8.5 per cent when Brazil's values were included), which could be proof that price suppression is *insignificant*. The Panel's conclusion that 'price suppression' would be the outcome in all simulations neglects this important argument. Interestingly, even though it acknowledged that the Panel did indeed not take position on the

[1222] Panel Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 10.199.
[1223] See below Part II, Chapter 5, Section 5.1.3.2.2.
[1224] Without taking position, the Panel simply concluded that 'the model needs to earn the confidence of this Panel' because it was submitted for the first time to this dispute.
[1225] Panel Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 10.222. The Panel also listed the economic modeling argument by Brazil as less persuasive. Panel Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 10.251.
[1226] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, paras 358, 434.
[1227] The weakness in the US argumentation was that the US did not propose an alternative model and also suggested alternative parameters to be used in the model proposed by Brazil.

significance of the results, the Appellate Body at the same time reached itself the conclusion that:

> The range of price effects resulting from the simulations would fall within the Panel's view of what constitutes "significant" price suppression in the specific context of the world price of upland cotton.[1228]

Recalling that the Panel did not set the required degree of significance too high with regard to upland cotton (see above), the Appellate Body thus suggested that a price suppression of approximately 1 per cent *would* have been considered significant by the Panel. Only if the Panel would effectively have reached this conclusion would it be excused, in my opinion, from taking position on which set of parameter values was appropriate.

Thus, the Appellate Body did ultimately not find an error of law in the Panel's assessment. Yet, the weight it attached to economic modeling seems to suggest that the Appellate Body will take a stricter stance on panels' evaluation thereof in future cases.[1229] Indeed, it emphasized that an analysis of price suppression 'would normally include a quantitative component'.[1230] Acknowledging that quantification of the subsidy effect is inherently difficult because the price increase absent the subsidy cannot be directly observed, the Appellate Body referred to the use of economic modeling or other quantitative techniques to estimate 'whether there are higher levels of production resulting from the subsidies and, in turn, the price effects of that production'.[1231] Because of the counterfactual nature of the analysis, 'modeling exercises are likely to be an *important tool* that a panel should scrutinize'.[1232] The complexity of such models and their parameters could not be an excuse for panels 'to remain agnostic about them'.[1233] As the initial trier of facts under a serious prejudice case, the panel should reach conclusions on the probative value it accords to economic simulations or models presented to it.[1234]

In the literature as well, several economists have stressed that economic analysis should be part of the serious prejudice determination since other relevant factors (e.g., trend analysis) cannot establish a causal relationship. Economic simulating models seem to be the prime

[1228] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, paras 365, 435.
[1229] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, paras 358, 434. Davey and Sapir point to the evolution made by the Appellate Body since the original procedure. See W. J. Davey and A. Sapir, 'United States – Subsidies on Upland Cotton Recourse to Article 21.5 by Brazil, WT/DS267/AB/RW (2 June 2008)', 9:1 *World Trade Review* (2010), 1-19.
[1230] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 356.
[1231] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 356.
[1232] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 357 (emphasis added).
[1233] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 357.
[1234] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 357.

quantitative tool given that econometric models (e.g., regression analysis), which establish statistically the relationship between two or more variables (e.g., subsidy and price) and are used in trade remedy cases, cannot be used under the serious prejudice analysis since, as Trachtman and Sapir point to, there is a lack of sufficient observations of the independent variable (i.e., subsidy).[1235,1236] At the same time, economists have emphasized that economic simulating models should be approached with caution. They refer to the structure as well as to the parameters used in such modeling. Regarding the structure of the model, Sapir and Trachtman were critical about the so-called 'calibration model' relied upon in the *US – Upland Cotton* case because the assumptions underlying the model were not tested. In contrast to econometric models, which use statistical techniques to test their validity, 'economic simulating models' simply assume an equilibrium process that links the variables in a specific way.[1237,1238] For instance, Vandenbussche indicates that the model used in the *US – Upland Cotton* case assumes a competitive market structure in upland cotton, in which prices are determined by interaction between world demand and supply, and assumes that upland cotton is a homogeneous type of product. Nonetheless, she also underlines that such assumptions could be tested.[1239] Likewise, Sapir and Trachtman finally conclude that one should not overestimate the fact that economic simulating models are not estimated as it is possible to test the robustness of the model's prediction.[1240] The parameter values (e.g., elasticities) included in the models are based on economic studies and thus seem reliable. The fact that different economic studies might differ widely on the value of these parameters, as shown in the *Upland Cotton* case, might again suggest that these studies should be examined critically. If panels accept the structure of the model and the used parameters, economic

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[1235] See Sapir and Trachtman, above n 1195, at 201-205.

[1236] On the other hand, Steinberg and Josling do not exclude the use of regression analysis in the context of Article 6.3(a), (b) and 6.4 of the SCM Agreement. They tackled the problem of the lack of sufficient observations by pooling time series and cross-section data (i.e., aggregating ten potential claims). Because price is affected by a large number of independent variables, modeling was used in the application of Article 6.3(c) of the SCM Agreement. See Steinberg and Josling, above n 1153, at 397-400. As Sapir points to, pooling of data is certainly not a precise tool to be used in a specific claim but its appropriateness depends on how far the specific claim is from the average of the other claims.

[1237] Sapir and Trachtman, above n 1195, at 202. To be precise, Trachtman and Sapir contrast 'calibration models' (as the one used by Brazil in the *US – Upland Cotton case*) with 'estimated econometric models'. Yet, 'estimated econometric models' face the same hurdles regarding data requirements as regression analysis as they are precisely estimated using regression analysis and seem therefore not an option for the serious prejudice analysis either. Hence, economic models used under the serious prejudice analysis will be 'calibrated models'.

[1238] 'General equilibrium' models, which include conceptually the entire economy and 'partial equilibrium' models, which separate part of such reality, are distinguished. See Steinberg and Josling, above n 1153, at 392.

[1239] H. Vandenbussche, 'Comment – Upland Cotton Case', 7:1 *World Trade Review* (2008), 211-217, at 212-215.

[1240] Sapir and Trachtman, above n 1195, at 183-209; see also Steinberg and Josling, above n 1153, at 393 simulating models can be very useful to quantify, by estimation, the effect of the subsidy on the world price.[1241]

Because of the importance – but also potential pitfalls – of economic simulation models, panels should make better use of the input of economic experts. One option advanced by Sapir and Trachtman is to set up 'expert review groups' on the basis of Article 13.2 of the DSU.[1242] Panels might be well advised to explore this suggestion as the Appellate Body has underscored the import of economic modeling exercises for the serious prejudice analysis and warned that panels should not remain agnostic about them. Such an economic expert group is not only helpful for panels to construct their own economic model and parameters – which the Appellate Body does not seem to require – but also to reach a conclusion on the probative value they have to accord to economic models and parameters presented by the parties.

4.2.3.3.2.4. Collective assessment and non-attribution

On the basis of all three previous discussed elements collectively, the Panel in the compliance procedure reached the conclusion that US cotton subsidies caused significant price suppression.[1243] This conclusion was mainly derived from those factors related to the subsidy and its production stimulating effect since the outcome of the trend analysis and economic modeling exercise was considered less persuasive.[1244] Although panels are not required to make a determination of 'significance' regarding each factor individually,[1245] the Appellate Body nonetheless faulted the compliance Panel for not giving 'a clearer explanation' of how the examined factors supported its finding that price suppression was indeed *significant*.[1246]

To reach such an affirmative conclusion of price suppression, should panels, like investigating authorities in case of trade remedies, also conduct a non-attribution analysis? Put otherwise, should panels explicitly rule out that other factors causing price suppression are not attributed to subsidies? In the context of CVDs investigations, investigating authorities should explicitly determine that any known factors other than subsidized imports which at the same time are injuring the domestic industry are not attributed to subsidized imports (Article 15.5

[1241] Sapir and Trachtman, above n 1195, at 204.

[1242] The option to establish a Permanent Group of Experts (Article 24 of the SCM Agreement) is not available under the current rules as it is limited to prohibited subsidy cases (below n 1284). See Trachtman and Sapir, at 205-207; Vandenbussche, above n 1239, at 216-217.

[1243] Panel Report, *US – Upland Cotton (Brazil – Article 21.5)*, paras 10.244-10.257.

[1244] In this respect, notice that the Appellate Body had acknowledged that '(a)ll else being equal, the marginal production attributable to the subsidy would be expected to have an effect on world prices, particularly if the subsidy is provided in a country with a meaningful share of world output'. Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 355.

[1245] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 418.

[1246] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 361.

of the SCM Agreement).[1247] The absence of such a specific non-attribution requirement in Article 6.3 of the SCM Agreement gives panels, according to the Appellate Body, 'a certain degree of discretion in selecting an appropriate methodology for determining whether the "effect" of a subsidy is significant price suppression under Article 6.3(c)'.[1248] At the same time, the Appellate Body concurred with the original Panel in *US – Upland Cotton* that 'it is necessary to ensure that the effects of other factors on prices are not improperly attributed to the challenged subsidies' since Article 6.3(c) requires that the effect *of the subsidy* is significant price suppression.[1249] At the compliance level, the Appellate Body reiterated this balanced view on the need to conduct a non-attribution analysis in relation to the required strength of the causation element:

> Article 6.3(c) requires the Panel to have ensured that the effects of other factors on prices did not dilute the "genuine and substantial" link between the subsidies and the price suppression, Article 6.3(c) leaves some discretion to panels in choosing the methodology used for this assessment.[1250]

'In light of this flexibility', the Appellate Body somewhat cryptically continued, 'it would not have been improper for the Panel to have assessed the effect of other factors as part of its counterfactual analysis, rather than conducting a separate analysis of non-attribution'.[1251] This conclusion might be somewhat surprising given that the compliance Panel had simply not undertaken any non-attribution analysis at all. Whereas the original Panel had made such an analysis as part of its bifurcated approach, the compliance Panel decided that it was not necessary in light of its unitary approach 'to undertake a comprehensive evaluation of factors affecting the world market price for upland cotton'.[1252] Turning to the US argument on China's significant role in the market for upland cotton, which was the only factor raised by the US in the context of the non-attribution requirement, the Panel had found that its influence on demand and supply does 'not change the fact that, with a share of world exports of around 40 per cent, the United States is capable of exerting a substantial proportionate influence on the world market'.[1253] In essence, the Panel thus argued that the price suppressing effect of US subsidies would not be neutralized by other factors such as China's role in the cotton

[1247] See also Appellate Body Report, *US – Upland Cotton*, para 436. See below Part II, Chapter 5, Section 5.2.2.3.
[1248] Appellate Body Report, *US – Upland Cotton*, para 436; Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 370.
[1249] Appellate Body Report, *US – Upland Cotton*, para 437. The non-attribution requirements spelled out in Part V 'must not be automatically transposed into Part III of the SCM Agreement' but may, nevertheless, 'suggest ways of assessing whether the effect of a subsidy is significant price suppression rather than it being the effect of other factors'. Appellate Body Report, *US – Upland Cotton*, para 438.
[1250] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 375.
[1251] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 375.
[1252] Panel Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 10.243.
[1253] Panel Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 10.243.

market. In light of the Panel's unitary approach, this conclusion is defensible from a conceptual viewpoint since other factors are already implicitly taken into account under the relevant subsidy related factors. For instance, China's more dominant role on supply and demand would be reflected in the US share on the world cotton market, in the relevant parameters of the economic modeling exercise (e.g., demand and supply elasticity), and in the trend analysis (e.g., price trend). However, by reading a non-attribution assessment into the Panel's analysis – which was thus rather a dismissal that such an assessment had to be made – the Appellate Body seems to suggest that non-attribution of other factors suggested by the parties should be explicitly addressed under a unitary approach. This could also be derived from the fact that the Appellate Body itself looked into the substance of the US argument and found that the US had failed to underpin its argument that this would have caused price suppression. The increase in imports and consumption of upland cotton in China would rather have put upward pressure on the price.[1254] In sum, panels do not have to meet the demanding non-attribution condition spelled out in the context of trade remedies but future panels might have to devote more attention to a non-attribution assessment even if they conduct a unitary assessment.

Recognizing that some divergence might be justified since CVDs-investigating authorities could be biased, Davey and Sapir have, nonetheless, criticized the stark difference between the demanding non-attribution requirement imposed upon CVDs-investigating authorities and this more flexible stance towards panels.[1255] However, three further observations seem relevant to nuance this stark difference. First, the Appellate Body's flexible stance regarding this panel report might be partly inspired on the basis of the weakness of the substance of the US argumentation. Second, the Appellate Body's reasoning also seems to suggest that future panels will have to conduct a proper non-attribution assessment regardless of whether they undertake a bifurcated or unitary approach. Third and finally, the more demanding non-attribution requirement upon CVDs-investigating authorities seems somewhat tempered by a less demanding causality requirement. After all, in the context of CVDs, the investigating authority could determine the impact of '*subsidized imports*' upon the domestic industry, whereas 'serious prejudice' should be the 'effect of *the subsidy*'. This implies that regression analysis quantifying the effect of subsidized imports (and non-attributing other factors) could be relied upon in a CVDs procedure in order to meet the causality requirement.[1256] In contrast, it was illustrated that quantification of the subsidy effect in a 'serious prejudice'

[1254] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, para 378.
[1255] Davey and Sapir, above n 1229, at 14-15.
[1256] This could likewise be used in a multilateral claim on the basis of Article 5(a) of the SCM Agreement.

claim will have to rely on a demanding economic modeling exercise, which is considered an important tool to meet the causality requirement.

4.3. NON-ACTIONABLE SUBSIDIES

Under the original SCM Agreement, an actionable subsidy claim as explained in the previous section could not be undertaken against a limited group of subsidies. This group of green light subsidies could also not be countervailed. During the Uruguay Round, the US had taken the most defensive position on the scope of subsidies that would be given green light as their purported legitimate objective could easily be circumvented by firms as well as governments. Because of 'the fungible nature of money', firms receiving, for example, research and development (R&D) subsidies could simply reallocate resources normally used for R&D to another purpose.[1257] Moreover, 'identifying non-actionable subsidies is inherently a dangerous task' because governments could simply rename prohibited or actionable subsidies as green light subsidies.[1258] This negative stance altered with regard to R&D subsidies when the Clinton Administration came to power (1993).[1259] Other negotiating countries were generally more open to the inclusion of green light subsidies so as to place such subsidies outside the scope of CVDs action. Ultimately, three subsidy categories were, under strict conditions, considered non-actionable but their green light status extinguished at the end of the 1999.[1260,1261] A short introduction of their previous green light status seems useful, not only because WTO Members might reconsider their re-inclusion in the Doha Round but in the purpose of the normative assessment conducted in Part IV as well.

[1257] See *Submission by the United States* (MTN.GNG/NG10/W/29, 22 November 1989).
[1258] Despite these reservations, the US had proposed a list of subsidies that could be considered non-actionable. See *Submission by the United States* (MTN.GNG/NG10/W/29, 22 November 1989).
[1259] The US even successfully pushed for widening the scope of R&D subsidies as foreseen in the Dunkel Draft, which in the view of the Clinton administration 'tied (their) hands when it came to investing in research and development'. One of the concerns raised in US Congress was that US public-private 'technology partnerships' would be targeted by CVDs action. Strategic trade theory (see above Part I, Chapter 2, Section 2.1) also provided new arguments for such subsidies. See Kleinfeld and Kaye, above n 610, at 51-52; J. Odell and B. Eichengreen, 'The United States, the ITO, and the WTO: Exit Options, Agent Slack, and Presidential Leadership', in A. O. Krueger (ed), *The WTO as an International Organization* (Chicago: The University of Chicago Press, 1998), 181-209, at 203; L. W. Nowicky, 'Alternative Approaches to International Competiveness: Does the Clinton Administration Need French Lessons?', in M. E. Kreinnin (ed), *Contemporary Issues in Commercial Policy* (Oxford: Pergamon, 1995), 191-202, at 193; H. A. Hazard, 'Microeconomic Initiatives to Promote Technology and Industry in the United States', in M. E. Kreinnin (ed), *Contemporary Issues in Commercial Policy* (Oxford: Pergamon, 1995), 185-190.
[1260] Previous drafts had listed more types of green light subsidies but the EC finally agreed to the US demand to reduce the list in exchange for less demanding language under Article 6.1 of the SCM Agreement. See Stewart, above n 579, at 911.
[1261] Politically, these were mainly created on the demand of the EC (focusing on R&D, environment), Canada (focusing on assistance to disadvantaged regions), and Mexico (which successfully pushed for environmental subsidies in the last days of negotiations). Stewart, above n 579, at 907; Collins-Williams and Salember, above n 626, 10–11. Regarding the shift in US stance on R&D subsidies, see above n 1259.

First, certain subsidies for R&D conducted by firms or by higher education or research establishments on a contract basis with firms were non-actionable, although this was limited to a certain level and to certain types.[1262] Second, non-actionable was likewise assistance to disadvantaged regions if the geographical region was clearly defined and the determination was based on neutral and objective criteria.[1263] The third category covered a limited type of environmental subsidy, namely assistance to promote adaptation of existing facilities to new environmental requirements.[1264] In principle, covered subsidies could not be challenged or countervailed, regardless of their generated trade effects.[1265]

The SCM Agreement provided for a notification requirement for such non-actionable subsidies, but no single formal notification was made over the entire period that this non-actionable subsidy category was in place.[1266] In fact, Members had to notify the SCM Committee all subsidy programmes they wanted to classify as non-actionable, and these notifications had to be made in advance of the implementation of the subsidy programme.[1267] When another Member disputed the non-actionable nature of a subsidy, it could start a review procedure that could end in binding arbitration.[1268] If a subsidy was not notified, it could in principle not benefit from non-actionability and became thus actionable and countervailable if it caused adverse effects or injury, respectively.[1269] However – and this was the weak spot of the notification procedure – such subsidies were still non-actionable if it was found during a countervailing or multilateral proceeding that they conformed to the standards of one of the three categories.[1270]

The category of green light subsidies was thus extinguished at the end of 1999 because there was no consensus among WTO Members to continue its application. As mentioned, the discussion was linked to the extension of Article 6.1 of the SCM Agreement. Several developing countries, such as Brazil and India, were not in favor of the extension in its existing form because the categories overly reflected the interest of developed countries. The EC and Canada, in contrast, favored a continuation of the category of non-actionable

[1262] See Article 8.2(a) of the SCM Agreement. Excluded from the SCM Agreement were subsidies for 'fundamental research' independently conducted by higher education or research establishments (footnote 26 of the SCM Agreement).
[1263] Article 8.2(b) of the SCM Agreement. See also Matsushita, Schoenbaum, and Mavroidis, above n 721, at 283.
[1264] Article 8.2(c) of the SCM Agreement. See also Matsushita, Schoenbaum, and Mavroidis, above n 721, at 284.
[1265] See below (Part II, Chapter 5, Section 5.1.3.3) on the multilateral remedy to respond to non-actionable subsidies.
[1266] *Background Note by the Secretariat, Notification Requirements under the Agreement on Subsidies and Countervailing Measures* (G/SCM/W/546, 28 April 2009), para 16.
[1267] See Article 24.1 of the SCM Agreement.
[1268] See Articles 8.3-8.5 of the SCM Agreement.
[1269] See footnote 35 of the SCM Agreement.
[1270] See footnote 35, *in fine* of the SCM Agreement.

subsidies, whereas the US articulated its 'mixed views on the provisions'. In general, there seemed not even a consensus present among either developed countries or developing countries.[1271] Therefore, it seems unlikely that WTO Members in the current Doha Round will reinstall this category in its present form. Nonetheless, Part IV of this study will discuss in detail whether their re-inclusion seems warranted.[1272]

[1271] See *Minutes of the Regular Meeting Held on 1-2 November 1999* (G/SCM/M/24, 26 April 2000); *Minutes of the Special Meeting Held on 20 December 1999* (G/SCM/M/22, 17 February 2000).
[1272] See below Part IV, Chapter 2, Section 2.1.1.

5. REMEDIES

In addressing the remedies to subsidies, three situations, each indicating a different effect of a subsidy, should be carefully distinguished.[1273] First, subsidies of country A can increase the export of product X into the *importing country*, country B, causing harm to the domestic producers of product X in country B. Second, subsidies of country A can increase the export of product X into *a third country*, country C, causing harm to the export to country C of product X from country B producers. Third, country A can subsidize domestic producers of product X to restrain the imports of product X in its *domestic market*, whereby the subsidy has the effect of an import barrier.

How can country B respond to these subsidies? Only in the first situation can country B impose CVDs to offset the price effect of the subsidy. Hereby, the subsidy of country A could, evidently, remain in force. In situations 2 and 3, country B cannot respond with CVDs because the harm it wishes to neutralize is not the importation of the subsidized product X. Of course, in situation 2, country B may request country C to impose CVDs, but this country might in fact welcome the subsidization of product X because it improves its overall welfare.[1274] So, how should country B respond in situations 2 and 3 if it wishes to protect the interests of its exporters of product X? From an economic viewpoint, country B can respond with an equivalent subsidy to its own producers of product X to neutralize the competitive disadvantage in countries A and C,[1275] but this subsidy will also be prohibited, as an export subsidy, or actionable under the SCM Agreement. Consequently, the only option for country B is to have recourse to the WTO-adjudicating bodies. If a Panel concludes that the subsidy of country A is prohibited/actionable, country A will have to withdraw the subsidy (prohibited) or at least remove the adverse effects of it (actionable).[1276] Only if country A does not take these steps might country B be authorized to adopt countermeasures.

As a result, the SCM Agreement provides two remedies to take action against prohibited and actionable subsidies granted by other WTO Members, which will be discussed in depth in this Chapter. First, in all three situations, country B can follow the multilateral approach and bring the case before the WTO-adjudicating bodies. Second, subject to a set of procedural and substantive requirements, country B can unilaterally impose CVDs to offset the effects of

[1273] See Jackson, above n 588, 280; Trebilcock and Howse, above n 894, at 263.
[1274] As explained above, Article VI:6(b),(c) of the GATT offers a limited option for Country C, whose own domestic industry is not injured by subsidized imports (e.g., lack of domestic industry), to impose CVDs so as to protect the interests in its territory of exporters from a trading partner (in this case, Country B) (see above n 555, 562). Apparently, this option is never used. See Steinberg and Josling, above n 1153, at 381, footnote 36.
[1275] Trebilcock and Howse, above n 894, at 263.
[1276] Withdrawal is also a possible remedy for actionable subsidies.

the subsidy in its domestic market (situation 1). The SCM Agreement clarifies the delineation between both options:

> However, with regard to the effects of a particular subsidy in the domestic market of the importing Member, only one form of relief (either a countervailing duty, if the requirements of Part V are met, or a countermeasure under Articles 4 or 7) shall be available.[1277]

Country B therefore can, but also should, choose between the unilateral or multilateral option to respond to the injury caused in its domestic market (situation 1). Yet, the SCM Agreement does not prohibit it pursuing the unilateral approach to offset the negative effects in its domestic market (situation 1), alongside the multilateral approach to address the negative effects of the same subsidy in its export markets (situations 2 and 3).[1278]

5.1. MULTILATERAL REMEDIES: WTO DISPUTE SETTLEMENT SYSTEM

WTO Members confronted with prohibited and actionable subsidies imposed by other WTO Members may take recourse to the WTO dispute-settlement system. The SCM Agreement stipulates specific dispute-settlement procedure rules for prohibited subsidies[1279] and for actionable subsidies,[1280] which are 'specific or additional' to the rules of the Dispute Settlement Understanding (DSU).[1281] The deadlines, implementation standards, and potential remedies in case of non-compliance are more stringent with regard to prohibited subsidies vis-à-vis actionable subsidies.

5.1.1. Time frame

The SCM Agreement provides for an accelerated procedure available to WTO Members confronted with prohibited and actionable subsidies.[1282] If consultations fail within 30 days under the prohibited subsidy procedure, the complaining Member may then refer the matter to the Dispute Settlement Body (DSB). Regarding actionable subsidies, the standard term of 60 days applies, but the term for the panel's composition is shorter.[1283] The time limits for the panel procedure are under both procedures substantially shorter than under the standard procedure of the DSU,[1284] and those for the Appellate Body procedure are shorter with regard

[1277] Article 10, footnote 35 of the SCM Agreement.
[1278] Matsushita, Schoenbaum, and Mavroidis, above n 721, 336.
[1279] Article 4 of the SCM Agreement.
[1280] Article 7 of the SCM Agreement.
[1281] The specific procedure is thus a *lex specialis*. In other words, the DSU is still relevant insofar this is not modified by the specific procedure (see Appendix 2 DSU and Article 30 of the SCM Agreement).
[1282] See also Article 4.2 of the SCM Agreement.
[1283] Article 7.4 of the SCM Agreement. Compare with Articles 4.7, 6, and 8 of the DSU.
[1284] See Articles 4.6 and 7.5 of the SCM Agreement. Compare with Articles 12, 15, and 16 of the DSU. Under the prohibited subsidy procedure, the Panel may request assistance of the Permanent

to prohibited subsidies.[1285] Moreover, the time period for the DSB to decide upon the adoption of the panel and Appellate Body reports is shorter under the SCM procedures.[1286] Last, if the subsidizing Member has not conformed to the DSB's ruling and recommendations within the time period indicated by the Panel (prohibited subsidies[1287]) or within six months (actionable subsidies), the affected Member will have the right to request authorization to adopt countermeasures.[1288]

5.1.2. Information gathering

In case a complaining Member aims at formulating a 'serious prejudice' claim involving actionable subsidies (Part III), it could rely on a specific procedure to collect information elaborated in Annex V of the SCM Agreement. This Annex reflects the awareness among drafters that gathering exact information on volume and/or price effects in the subsidizing country and/or third countries might be notoriously difficult. Indeed, the subsidizing Member, whose subsidies are challenged, might be reluctant to cooperate and third countries might also not be very keen to provide information on price and/or volume effects of subsidized imports given that such subsidized imports could very well be welfare improving from their perspective.[1289] To obtain such information, the complaining party could request the Dispute Settlement Body to initiate the Annex V procedure.[1290] If so, a representative will be designated by the Dispute Settlement Body to facilitate the information gathering process.[1291] This information-gathering process has to be completed within 60 days, after which the information obtained is submitted to the panel. During this process, the complaining party could request the *subsidizing country* for relevant information (e.g., through questionnaires). This could cover information needed to analyze the adverse effects caused by the subsidized product, to establish the existence and amount of subsidization, and

Group of Experts (PGE), composed of five experts elected by the SCM Committee, with regard to whether the measure in question is a prohibited subsidy. Although reference to the PGE is optional, the determination of the PGE is binding upon the Panel (see Articles 24.3 and 4.5 of the SCM Agreement). This might be the reason why so far no panel has requested the determination of the PGE. See Clarke and Horlick, above n 587, at 726; J. Kazeki, 'Permanent Group of Experts under the SCM Agreement', 43:5 *Journal of World Trade* (2009), 1031-1045, at 1033-1034, 1041.

[1285] See Articles 4.9, 7.7 of the SCM Agreement. Compare with Article 17.5 of the DSU.

[1286] Articles 4.8 and 4.9 of the SCM Agreement and Articles 7.6 and 7.7 of the SCM Agreement. Compare with Articles 16.4 and 17.14 of the DSU.

[1287] The measure will have to be withdrawn without delay (see below Part II, Chapter 5, Section 5.1.3.1.1).

[1288] Articles 4.10 and 7.9 of the SCM Agreement. Compare with the 'reasonable period' stipulated by Articles 21.3 and 22.2 of the DSU.

[1289] This holds when these countries are net-importing countries.

[1290] Annex V also foresees in the general obligation upon every Member to cooperate in the development of evidence when an actionable subsidy claim is formulated (Article 7 of the SCM Agreement). See paragraph 1 of Annex V.

[1291] Paragraph 2 *juncto* 4 of Annex V of the SCM Agreement.

to get insight in the value of total sales of the subsidized firms.[1292,1293] Next, *third country Members* are, pursuant to Article 6.6 of the SCM Agreement, obliged to make available to the parties to a dispute and the panel 'all relevant information that can be obtained as to the changes in market shares of the parties to the dispute as well as concerning prices of the products involved'. Paragraph 3 of Annex V of the SCM Agreement further specifies this requirement and hereby aims at striking a balance between the need for parties in the dispute to obtain such information and the burden this could impose on third countries. For example, information could be obtained through questionnaires but may not impose an unreasonable burden on third countries.[1294] In case the subsidizing and/or third-country Member fail to cooperate, the claim of 'serious prejudice' will be decided on the basis of available evidence[1295] and the panel should 'draw adverse inferences' from such failure when making its determination.[1296]

This procedure stipulated in Annex V of the SCM Agreement could be used to gather information in case a 'serious prejudice'-claim is formulated under Part III of the SCM Agreement.[1297] In contrast, no such specific procedure is established to facilitate a prohibited subsidy claim (Part II of the SCM Agreement). Nonetheless, the absence of such procedure does not seem to hamper information gathering in case a prohibited subsidy claim is introduced.[1298] First, the Appellate Body has held that the panels' authority to draw adverse inferences from non-cooperation, which is only explicitly provided under Annex V for

[1292] Paragraph 2 of Annex V of the SCM Agreement.
[1293] Such a representative was designated in *Korea – Commercial Vessels* and *Indonesia – Autos*. See Panel Report, *Korea – Commercial Vessels*, Attachment 1. The representative in *Korea – Commercial Vessels* decided on several procedural questions raised under the Annex V procedure.
[1294] For further details, see paragraph 3 of Annex V of the SCM Agreement.
[1295] It is further specified that the panel could complete the record as necessary relying on best information otherwise available. Paragraph 6 of Annex V of the SCM Agreement.
[1296] Such adverse inferences should be drawn from instances of non-cooperation by *any party* involved in the information-gathering process. Paragraph 7 of Annex V of the SCM Agreement
[1297] See also Appellate Body Report, *Canada – Aircraft*, para 201. It could be debated whether it also applies to other types of adverse effects (i.e., Article 5 (a) (injury to the domestic industry) and Article 5 (b) (nullification and impairment)). The title of Annex V specifically refers to cases of serious prejudice ('Procedures for developing information concerning serious prejudice') and the Appellate Body has observed that Annex V 'deals with procedures for developing information about "serious prejudice" in cases involving actionable subsidies (…)' (Appellate Body Report, *Canada – Aircraft*, para 201). On the other hand, the text of paragraph 2 of Annex V refers in general terms to cases where matters are referred to the Dispute Settlement Body 'under paragraph 4 of Article 7'. Anyway, a complaining Member could also simply open the procedure of Annex V by bringing an additional claim of serious prejudice and use this information for its other claims of adverse effects.
[1298] The reason why no such specific procedure is elaborated regarding prohibited subsidies might be that no adverse effects should be demonstrated in case of prohibited subsidies. Yet, the information gathering procedure could still be relevant, for example, to demonstrate the presence of a 'subsidy' under Article 1 of the SCM Agreement.

actionable subsidies, *a fortiori* applies to claims of prohibited subsidies.[1299] Second, the Panel in *Korea – Commercial Vessels* considered that it could seek the very same information relevant for a prohibited subsidy claim (e.g., existence of subsidy) on the basis of Article 13.1 of the DSU (i.e., right to seek information). Because the information would thus be obtained anyway, the same Panel decided that information gathered under the Annex V procedure could also be used by the complaining Member for supporting its claim under Part II (prohibited subsidy).[1300]

5.1.3. Implementation standard and remedies in case of non-implementation

The SCM Agreement contains specific legal implementation obligations and remedies in case a successful subsidy claim has been formulated. On both aspects, the SCM Agreement differentiates between prohibited and actionable subsidy violations.

5.1.3.1. Prohibited subsidies

5.1.3.1.1. Implementation

If the measure is found to be a prohibited subsidy, the subsidizing Member has to 'withdraw the subsidy without delay'.[1301] In particular, the panel has to specify the time period within which the measure must be withdrawn. The subsidizing Member is thus not given 'a reasonable period of time' to bring its measure in conformity with WTO rules, as is the case under the DSU. Moreover, the subsidizing Member has no other options than to withdraw the subsidy, whereas the DSU leaves it upon the losing party to determine how to bring its measure into compliance with WTO law.[1302]

Obviously, such compliance cannot be achieved by simply replacing the original subsidy with another subsidy found to be prohibited.[1303] Yet, a highly sensitive issue is whether the term 'withdraw' may encompass repayments of previously granted prohibited subsidies. The Panel in *Australia – Automotive Leather II (Article 21.5 – US)*, a case involving a one-time, non-recurring prohibited subsidy from Australia to a private company, adopted such an extensive interpretation and required that the subsidy had to be repaid in full by the private company.[1304]

[1299] Appellate Body Report, *Canada – Aircraft*, para 202; Panel Report, *Korea – Commercial Vessels*, para 7.162.
[1300] Panel Report, *Korea – Commercial Vessel*s, paras 7.3-7.5.
[1301] Article 4.6 of the SCM Agreement.
[1302] Compare Article 19.1 of the DSU and Article 4.7 of the SCM Agreement.
[1303] Appellate Body Report, *US – FSC (Article 21.5 – EC II),* para 83. See also below n 1357.
[1304] Panel Report, *Australia – Automotive Leather II (Article 21.5 – US)*. For a critical appraisal of this Panel Report, see G. Goh and A. Ziegler, 'Retrospective Remedies in the WTO After *Automotive Leather*', 6:3 *Journal of International Economic Law* (2003), 545–564.

A central motivation of the Panel was to uphold the effectiveness of the multilateral remedy if a one-time prohibited subsidy is provided:

> If we were to accept the conclusion that 'withdraw the subsidy' does not encompass repayment, then that recommendation, far from providing a remedy for violations of Article 3.1(a) of the SCM Agreement, would grant full absolution to Members who grant export subsidies that are fully disbursed to the recipient before a recommendation to withdraw the subsidy is issued in dispute settlement, and for which the export contingency is entirely in the past.[1305]

Indeed, otherwise WTO Members could easily circumvent the stringent disciplines on prohibited subsidies by providing non-recurring subsidies. However, it is argued that this interpretation constitutes a departure from the general principle that WTO law only provides for prospective remedies, as Article 19.1 of the DSU is generally interpreted.[1306] Moreover, the obligation to repay past subsidies might pose constitutional and democratic problems in some legal systems of WTO Members.[1307] Lastly, Waincymer remarks that it is extremely unlikely that negotiators during the Uruguay Round would have intended to have this niche area of retroactive remedies.[1308] It therefore comes as no surprise that many WTO Members criticized this interpretation of the Panel.[1309] In the Doha Round, Australia proposed clarifying the concept of 'withdrawal' and, interestingly, its most recent contribution would allow for repayment of the ongoing benefit since the adoption of the panel report.[1310] Yet, no amendment along these lines is inscribed in the latest Draft Consolidated Chair Text.[1311]

5.1.3.1.2. Remedy in case of non-implementation

If the recommendation of the DSB to withdraw the subsidy is not followed within an indicated time frame, the injured party may request to take *appropriate* countermeasures (Article 4.10 of the SCM Agreement).[1312] In contrast, the DSU uses the concept of

[1305] Panel Report, *Australia – Automotive Leather II (Article 21.5 – US)*, para 6.38. See also Panel Report, *Canada – Aircraft Credits and Guarantees*, para 7.170.
[1306] Article 19.1 of the DSU requires a Panel or the Appellate Body to 'recommend that the Member concerned bring the measure *into conformity with* that agreement' (emphasis added). This provision does not explicitly state that only prospective remedies are covered.
[1307] See Goh and Ziegler, above n 1304, at 555–559.
[1308] See J. Waincymer, *WTO Litigation – Procedural Aspects of Formal Dispute Settlement* (London: Cameron May, 2002), 935 pp., at 644–645.
[1309] This criticism was expressed in the DSB meeting adopting the Panel Report. See also Goh and Ziegler, above n 1304, at 547–548.
[1310] See *Communication from Australia*, *Subsidies: Withdrawal of a subsidy* (TN/RL/GEN/115/Rev.1, 24 January 2007).
[1311] Draft Consolidated Chair Text, above n 643.
[1312] The complaining party could request the DSB to authorize the adoption of 'appropriate' countermeasures but the defending could refer the matter to arbitration, for example, if it disagrees that the proposed level is appropriate (Article 4.10 and 4.11 of the SCM Agreement *juncto* Article 22.6 of the DSU). The party objecting to the proposed countermeasures (i.e., defending party) bears the initial

equivalence (see Article 22.4 of the DSU) and Article 7.8 of the SCM Agreement on remedies in the context of actionable subsidies uses the concept of 'commensurate with (...) the adverse effects'. In a footnote, the SCM Agreement clarifies, seemingly superfluously, that it is not meant to allow countermeasures that are disproportionate.[1313] It does, however, not indicate whether the amount of countermeasures should be based on the amount of the subsidy or on the amount of the injury to the complaining party (i.e., trade effect). Whereas the Arbitrators in the first three cases confronted with this question opted for the 'amount of the subsidy'-approach, the Arbitrator in *US – Upland Cotton* explicitly changed track towards a 'trade effect'-approach.

Indeed, in the first arbitration dealing with this issue, the Arbitrator[1314] in *Brazil – Aircraft* had decided that an amount of countermeasures that corresponds to the total amount of the subsidy is appropriate when dealing with a prohibited export subsidy.[1315] To reach this finding, it stressed the different purpose with respect to countermeasures under the DSU:

> The purpose of Article 4 is to achieve the *withdrawal* of the prohibited subsidy. In this respect, we consider that the requirement to withdraw a prohibited subsidy is of a different nature than removal of the specific nullification or impairment caused to a Member by the measure. The former aims at removing a measure which is presumed under the WTO Agreement to cause negative trade effects, irrespective of who suffers those trade effects and to what extent. The latter aims at eliminating the effects of a measure on the trade of a given Member.[1316]

So, the different nature of prohibited subsidies, as prohibited *per se* by the SCM Agreement and not conditioned upon a 'trade effects'-test, would legitimize countermeasures based on the full subsidy amount and not confined to the actual injury caused to the complaining party. Otherwise, if the injury is substantially lower than the subsidy, 'a countermeasure (…) will have less or no inducement effect and the subsidizing country may not withdraw the measure at issue'.[1317] At the same time, the Arbitrator recognized that 'given that export subsidies usually operate with a multiplying effect (a given amount allows a company to make a number of sales, thus gaining a foothold in a given market with the possibility to expand and gain market shares)', a calculation based on trade effects could very well produce higher

burden to establish a *prima facie* case or presumption that the countermeasures are not appropriate. See Decision by the Arbitrators, *Brazil – Aircraft (Article 22.6 – Brazil)*, paras 2.8-2.9.

[1313] Article 4.10, footnote 9 (and 10) of the SCM Agreement. See also Decision by the Arbitrators, *Brazil – Aircraft (Article 22.6 – Brazil)*, para 3.51. The Arbitrator in *US – Upland Cotton* found support in this footnote for its trade effect approach, whereas the Arbitrator in *US – FSC* found support that countermeasures should *not* be limited to trade effects (see below n 1332).

[1314] See Article 22.6 of the DSU and Article 4.11 of the SCM Agreement.

[1315] Decision by the Arbitrators, *Brazil – Aircraft (Article 22.6 – Brazil),* para 3.60.

[1316] Decision by the Arbitrators, *Brazil – Aircraft (Article 22.6 – Brazil)*, para 3.48 (footnotes deleted; emphasis in the original).

[1317] Decision by the Arbitrators, *Brazil – Aircraft (Article 22.6 – Brazil)*, para 3.54. The Arbitrators also rejected the claim that such an amount of countermeasures would be punitive (para 3.55).

figures than one based exclusively on the subsidy amount.[1318] Likewise, the Arbitrators in *US – FSC* and *Canada – Aircraft Credits and Guarantees* based countermeasures on the amount of the subsidy. [1319] Interestingly, the Arbitrator in *US – FSC* addressed a number of complex issues raised by this interpretation. What if there are multiple complainants, each seeking to take countermeasures in an amount equal to the value of the subsidy? Or, what if another WTO Member, subsequent to the challenge by the EC of the FSC measures, aimed to challenge the same measure? In the case of multiple complainants, the Arbitrator said that 'this would certainly have been taken into account' in the determination of the appropriateness of the countermeasures, and thus implicitly indicated that an amount equal to the value of the subsidy for each WTO Member would be considered inappropriate. With regard to the second hypothetical situation, the Arbitrator realized that the 'allocation issue would arise' and cited the EC's statement indicating that it would 'voluntarily agree to remove some of its countermeasures so as to provide more scope for another WTO Member to be authorized to do the same'.[1320] In concluding, the Arbitrator in *US – FSC* emphasized that its finding did not affect the right of other complainants to subsequently request countermeasures.[1321]

In line with this case law, both parties in *US – Upland Cotton* had taken recourse to the 'amount of the subsidy'-approach. Nonetheless, the Arbitrator shifted towards the 'trade effect' upon the complainant as basis to calculate the level of countermeasures.[1322] The Arbitrator reached this conclusion on the basis of the legal requirement that countermeasures should be 'appropriate'.[1323] In its view, this would suggest that 'there *should be a degree of relationship between* the level of countermeasures and the trade-distorting impact of the measure on the complaining Member' and, even though this is not entirely impossible, 'in most cases, the trade-distorting impact of the subsidy on one or several other Members would

[1318] The Arbitrator seemed to suggest that this would be so in the case at hand. Decision by the Arbitrators, *Brazil – Aircraft (Article 22.6 – Brazil)*, para 3.54.
[1319] Decision by the Arbitrator, *US – FSC (Article 22.6 – US)*, paras 5.41, 5.49, 6.33 (footnote 84), and 6.35; Decision by the Arbitrator, *Canada – Aircraft Credits and Guarantees (Article 22.6 – Canada)*, para 3.52.
[1320] Decision by the Arbitrator, *US – FSC (Article 22.6 – US)*, para 6.29.
[1321] Yet, the Arbitrator indirectly included a message for a potential future Arbitrator: '(…) it need only be stated that there is, in our view, no reason to presume that an arbitrator who might be required to address such a complaint in future would not take into account all the relevant factors in determining what might, at the time it is ruling, constitute 'appropriate countermeasures' in such future case'. Hereby, the Arbitrator referred to its findings in para 6.29, including to the EC's statement cited in that paragraph. Decision by the Arbitrator, *US – FSC (Article 22.6 – US)*, para 6.63.
[1322] Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, paras 4.121-4.138, 4.173-4.181.
[1323] Further, this was also based on footnote 9, which stipulates that countermeasures should not be 'disproportionate' (see below n 1332). Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, paras 4.135, 4.136.

not necessarily bear any particular relationship to the amount of the subsidy'.[1324] Even if 'the subsidy amount'-approach might seem attractive from a calculation perspective, the difficulty to measure trade effects upon the complaining Member should not withhold future arbitrators to undertake this exercise.[1325] Arbitrators should not reach a precise quantification of the actual trade effect but have the flexibility to accept approximations they feel to be within the bounds of what is appropriate in the case at hand.[1326]

The Arbitrator was well aware that previous arbitrators had taken a different approach, but, at the same time, noticed that they did not exclude trade effects as a relevant consideration.[1327] Indeed, the Arbitrators in *US – FSC* and *Canada – Aircraft Credits and Guarantees* did not preclude that the level of countermeasures calculated on the basis of the subsidy amount could be modified *upward* in case adverse trade effects upon the complainant would be higher.[1328] As indicated above, they recognized that the injury to the complainant might very well be higher than the subsidy amount in certain cases.[1329] Yet, these previous Arbitrators fundamentally differed from the Arbitrator's position in *US – Upland Cotton* in their conclusion that countermeasures should not be constrained to trade effects in case the subsidy amount turns out to be larger. They found no such limitation in Article 4 of the SCM Agreement and considered that such approach could undermine the inducement effect of countermeasures.[1330] By reading into Article 4.9 ('appropriate')[1331] and its footnote ('not be

[1324]Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, paras 4.135-4.136 (emphasis added). It could thus not be assumed that the 'amount of the subsidy' is an accurate proxy for the trade effect of a measure (para 4.135). The Arbitrator cited the Arbitrator in *US – FSC*: 'the proxy approach proposed by the United States is based on no particular economic rationale. It simply assumes a one-to-one correspondence of dollar of subsidy to dollar of trade impact. This is manifestly arbitrary'. Decision by the Arbitrator, *US – FSC (Article 22.6 – US)*, para 6.39; Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, para 4.169; Decision by the Arbitrators, *Brazil – Aircraft (Article 22.6 – Brazil),* footnote 53. As explained below, the Arbitrator in *US – Upland Cotton*, nonetheless, used the amount of the subsidy as a proxy for part of the trade effect (i.e., the price effect of the export subsidies).

[1325] Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, paras 4.134, 4.137.

[1326] Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, para 4.137.

[1327] Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, para 4.133.

[1328] 'The expression "appropriate countermeasures", in our view, would entitle the complaining Member to countermeasures which would at least counter the injurious effect of the persisting illegal measure on it'. See Decision by the Arbitrator, *US – FSC (Article 22.6 – US)*, para 5.21; Decision by the Arbitrator, *Canada – Aircraft Credits and Guarantees (Article 22.6 – Canada)*, paras 3.63, 3.114-3.116. See also Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, footnote 182.

[1329] Decision by the Arbitrators, *Brazil – Aircraft (Article 22.6 – Brazil)*, para 3.54; Decision by the Arbitrator, *US – FSC (Article 22.6 – US)*, footnotes 84, 88.

[1330] '(…) (I)t does not *require* trade effects to be the effective standard by which the appropriateness of countermeasures should be ascertained. Nor can the relevant provisions be interpreted to *limit* the assessment to this standard'. See Decision by the Arbitrator, *US – FSC (Article 22.6 – US)*, para 5.41

disproportionate')[1332] an obligation to relate countermeasures to the trade-distorting impact upon the complainant, the Arbitrator in *US – Upland Cotton* foreclosed an upward adaption of the level of countermeasures when the trade effect upon the complainant turns out to be lower than the subsidy amount. To paraphrase previous case law, such an interpretation does in my view 'effectively read the specific language' of Article 4 of the SCM Agreement 'out of the text'.[1333] Indeed, it largely equates the level of 'appropriate' countermeasures in the context of prohibited subsidies to the level *explicitly* foreseen in the context of actionable subsidy claims. The latter refers to countermeasures 'commensurate with the degree and nature of the adverse effects'.[1334] This difference in wording should be given meaning *an sich*. Moreover, the dissimilarity in wording suggests that in case 'negotiators have intended to limit countermeasures to the effect caused by the subsidy on a Member's trade, they have used different terms than "appropriate countermeasures"'.[1335] In contrast, the only difference between the level of countermeasures in the context of prohibited subsidies and those in the context of actionable subsidies (or other WTO contexts) is, in the reading of the Arbitrator in *US – Upland Cotton*, that arbitrators would have somewhat more flexibility to calculate the trade effect when confronted with prohibited subsidies.[1336] Hence, they might more easily adopt assumptions that would overestimate the trade effect upon the complainant. Apparently, any difference between both sets of countermeasures would simply result from the inaccuracy of the economic modeling exercise to calculate the trade effect upon the complainant. It seems highly doubtful that this was the differentiation intended by

(emphasis in the original). The concern of eroding the inducement effect was expressed by Decision by the Arbitrators, *Brazil – Aircraft (Article 22.6 – Brazil)*, para 3.54.

1331 The same reference is made in Article 4.10 of the SCM Agreement.

1332 Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, para 4.135. Footnotes 9 reads that '(t)his expression is not meant to allow countermeasures that are disproportionate *in light of the fact that the subsidies dealt with under these provisions are prohibited*' (emphasis added). The latter part could be understood in two opposing ways. On the one hand, it could mean that countermeasures should not be disproportionate simply because they are prohibited in nature. In this reading, apparently adopted by the Arbitrator in *US – Upland Cotton* (see above n 1323), footnote 9 would rather limit the amount of countermeasures that one might consider appropriate on the basis of the text of Article 4.10 itself. On the other hand, according to the Arbitrator in *US – FSC*, it means that, in determining whether countermeasures are disproportionate, it should be taken into account that these are prohibited and have to be withdrawn. In this reading, footnote 9 would rather underscore the difference with countermeasures in the context of actionable subsidies. Decision by the Arbitrator, *US – FSC (Article 22.6 – US)*, paras 5.15-5.27, 5.30, 5.43, 5.62.

1333 Decision by the Arbitrator, *US – FSC (Article 22.6 – US)*, para 5.62.

1334 Article 4.7 of the SCM Agreement. As indicated below, the Arbitrator in some instances accepted assumptions that would likely overestimate the real trade effect upon the complainant because it was dealing with countermeasures in the context of prohibited subsidies. Yet, the same Arbitrator also adopted such 'overestimating' assumptions in the context of actionable subsidies (see below Part II, Chapter 5, Section 5.1.3.2.2).

1335 Decision by the Arbitrators, *Brazil – Aircraft (Article 22.6 – Brazil),* para 3.49; see also Decision by the Arbitrator, *US – FSC (Article 22.6 – US)*, paras 5.32, 5.48.

1336 Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, paras 4.22, 4.107, 4.119; Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, para 4.55.

negotiators. Lastly, a higher level of countermeasures in case of prohibited subsidies also corresponds to the general stricter stance on these subsidies under the SCM Agreement. It relates the level of countermeasures to the gravity of the wrongful act.[1337] For all these reasons, the previous case law seems to be on more solid grounds in their conclusion that countermeasures should not be limited to the trade effect upon the complainant. Nonetheless, the 'trade effect'-approach endorsed by the Arbitrator in *US – Upland Cotton* merits some further scrutiny as future arbitrators will likely align themselves to this new approach.

In implementing this 'trade effect'-approach, the Arbitrator in *US – Upland Cotton* explained that, similar to any export subsidy, the subsidized export credit support could be expected to affect both the *volume* of trade and the *price* at which trade takes place.[1338] By stimulating additional US exports and inflating the price in target markets, such 'illegally subsidized competition' generates 'adverse effects upon producers and exporters in the rest of the world'.[1339] They will lose sales to US subsidized competitors in the target markets (i.e., *volume effect*) and will have to sell their remaining sales at the depressed price in these markets (i.e., *price effect*). Here, the Arbitrator clarified that the economic damage upon the complainant will not be based on the welfare effects caused by the export subsidies (i.e., how much does it make the complainant worse off in welfare terms) but on their allocation effects (i.e., the potential amount and value of trade affected by the export subsidy).[1340]
To calculate the volume effect, the displacement of both domestic production and third country exports was measured on the basis of the additional US exports that were generated by the subsidy programme. Equating displacement with additional exports assumed that US export subsidies did not create additional demand.[1341] Turning to the price effect, the Arbitrator decided to take the subsidy amount (i.e., the interest rate subsidy[1342]) as a proxy of

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[1337] For a detailed elaboration of this argument, see Decision by the Arbitrator, *US – FSC (Article 22.6 – US)*, paras 5.22-5.24, 5.39-5.41, 5.61.
[1338] Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, para 4.183.
[1339] Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, para 4.183.
[1340] The Arbitrator justified this focus by pointing to the fact that countermeasures will be in the form of the suspension of an amount of trade and that 'trade effects arise in response to the reallocation of resources' induced by export subsidies. Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, footnote 212.
[1341] The Arbitrator considered that such additional demand would likely be relatively small but acknowledged that to the extent it occurs, the measurement of additionality would overestimate the displacement. See Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, para 4.191.
[1342] The subsidy amount of the export credit guarantees was calculated on the basis of the Ohlin model (Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, paras 4.209, 4.232, 4.233). For more information on this model, see also OECD, *An Analysis of Officially Supported Export Credits in Agriculture* (COM/AGR/TD/WP(2000)91/FINAL, 2001), 62 pp., at 34-36.

the global revenue loss due to the price effect. Here, it was well aware that this was only a rude proxy, which would very likely overestimate the actual loss.[1343] Because the Arbitrator decided that countermeasures should be equivalent to the trade-distorting impact upon the complainant (i.e., Brazil), the figures of both the volume and price effect were apportioned to Brazil's market share.[1344] Adding the price effect and volume effect upon Brazil, the Arbitrator reached a level of nearly $150 million.

To reach this conclusion, the Arbitrator in essence relied upon the calculations made by Brazil for its claim based on the subsidy amount. Brazil had argued that the subsidized export credit support conferred a double benefit: an interest rate subsidy (IRS), affording foreign importers discounted financing, and 'additionality benefits', affording US exporters greater export quantities than under market conditions (additionality).[1345] Rightly refuting that these could be considered as distinct benefits,[1346] the Arbitrator tactfully used both elements for its trade effect calculation: the IRS as proxy for the price effect and additionality as measurement of the volume effect. By subsequently apportioning these trade effects to the market share of the complainant, the final level of countermeasures was substantially lower than the calculation based on the full subsidy amount. To fit the subsidy amount calculations into its trade effect approach, the Arbitrator was well aware that it had to adopt a set of rather unrealistic assumptions. In this regard, it emphasized the latitude in calculating the appropriate level of countermeasures because non-implementation of a prohibited subsidy finding was at stake.[1347]

In concluding, it should be highlighted that all arbitrators agreed that the purpose of countermeasures under Article 4 of the SCM Agreement is, as under the DSU,[1348] to *induce*

[1343] The set of assumptions was: (i) 100 per cent pass-through of the interest rate subsidy; (2) the export guarantee programme has no effect on the world market price (but only on domestic prices in the target markets); (3) the GSM-supported sales substitute on a one-to-one basis for either domestic production or unsubsidized imports; and (4) the supply curve of other supplies and the demand curve are perfectly inelastic and not responsive to price. Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, paras 4.196-4.198.

[1344] To be precise, no apportionment was made for the trade-distorting impact on Brazil's domestic market because it was assumed that all adverse effects occurred to domestic producers (and not to importers). Only the adverse effects in third markets were thus apportioned using Brazil's share of world trade.

[1345] Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, paras 4.139-4.147.

[1346] Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, paras 4.147-4.148, footnote 199. In my view, the benefits presented by Brazil are indeed two sides of the same coin: the IRS to foreign importers generates the additional sales for US exporters. For the trade effect approach adopted by the Arbitrator, both could very well be used as proxies for different types of adverse effects upon foreign competitors (i.e., price effect and volume effect) if a set of assumptions is accepted.

[1347] Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, paras 4.192, 4.198, 4.201.

[1348] Appellate Body Report, *US – Continued Suspension*, para. 309; Report by the Arbitrator, *EC – Bananas III (US) (Article 22.6 – EC)*, para 6.3.

compliance.[1349] Hence, the objective of countermeasures is not to compensate the complainant for non-compliance but, instead, to induce the subsidizing Member to withdraw the condemned export subsidies.[1350] Noteworthy, the Arbitrator in *Canada – Aircraft Credits and Guarantees* specified that its purpose is not to induce the complainant to deter the payment of prohibited subsidies in the *future*, and thus beyond those that were found prohibited by the panels and Appellate Body (deterrent argument).[1351] Although the Arbitrator in *US – Upland Cotton* accepted that 'inducing compliance' is indeed the purpose of countermeasures under Article 4 of the SCM Agreement, it stressed that this *purpose* should not have an impact on the *level* of countermeasures that may be permissible.[1352] The Arbitrator did not share the concern that the purpose of inducing compliance would be undermined if countermeasures are confined to trade effects in case these are substantially lower than the amount of subsidies.[1353]

The new approach adopted in the case law implies that the WTO dispute settlement system will present a less forceful and effective instrument for developing countries to challenge prohibited export subsidies. Given their relatively low share in trade, the level of countermeasures might be insufficient to induce compliance upon the complainant in case they challenge prohibited export or local content subsidies. Surely, this is similar to the level of countermeasures in case of non-implementation of other types of WTO obligations. Yet, the 'subsidy amount'-approach had the unique advantage that the level of countermeasures, and thus the inducement effect, did not depend on the market share of the complainant.[1354] This might be another argument why the 'subsidy amount'-approach should not have been rejected.

[1349] Decision by the Arbitrator, *US – FSC (Article 22.6 – US)*, paras 5.52, 5.57; Decision by the Arbitrator, *Canada – Aircraft Credits and Guarantees (Article 22.6 – Canada)*, paras 3.47-3.48; Decision by the Arbitrators, *Brazil – Aircraft (Article 22.6 – Brazil)*, paras 3.44, 3.54, 3.57 and 3.58.

[1350] For instance, the US unsuccessfully argued before the Arbitrator in *US – Upland Cotton* that the purpose of countermeasures was to 'rebalance rights and obligations'. Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, para 4.108

[1351] Decision by the Arbitrator, *Canada – Aircraft Credits and Guarantees*, paras 3.108-3.113.

[1352] The Arbitrator observed that inducing compliance 'appears rather to be the common purpose of retaliation measures in the WTO dispute settlement system (...)'. In those other contexts, countermeasures are also not above the level of trade effects. Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, para 4.112. See also Decision by the Arbitrator, *US – FSC (Article 22.6 – US)*, para 5.60. In contrast, the Arbitrator in in *Canada – Aircraft Credits and Guarantees* had increased (by 20 per cent) the level of countermeasures calculated on the basis of the amount of the subsidy in order to induce compliance because Canada had indicated that it did not intend to withdraw the export subsidy. Decision by the Arbitrator, *Canada – Aircraft Credits and Guarantees*, paras 3.121-3.122.

[1353] Compare with Decision by the Arbitrators, *Brazil – Aircraft (Article 22.6 – Brazil)*, para 3.54.

[1354] At least insofar the trade effect upon the complainant was not higher than the amount of the subsidy.

5.1.3.2. Actionable subsidies

5.1.3.2.1. Implementation

The legal obligations upon the subsidizing country regarding actionable subsidies are somewhat less stringent. Article 7.8 of the SCM Agreement allows the respondent to choose among two implementation options. It 'shall take appropriate steps to remove the adverse effects *or* shall withdraw the subsidy'.[1355] The subsidizing country is therefore not required to withdraw the subsidy as long as it removes its adverse effects, which should be done within six months from the date when the DSB adopts the panel or Appellate Body report. Implementation will thus normally require some positive action by the respondent Member so as to withdraw the subsidy or remove its adverse effects.[1356] But such action is according to the Appellate Body not limited to subsidies granted in the past, and which formed the panel's basis to reach the conclusion of serious prejudice. In case of recurring annual payments, implementation extends to subsidies maintained after the time period examined by the panel, as long as they continue to have adverse effects.[1357] A mere change in legal basis on which such subsidies are provided does not imply compliance.[1358]

5.1.3.2.2. Remedy in case of non-implementation

In case of non-compliance, the complainant could request authorization to take countermeasures 'commensurate with the degree and the nature of the adverse effects' (Article 7.9 of the SCM Agreement). Hence, the level of countermeasures can certainly not be based on the subsidy level. In essence, this conforms to the new 'trade effect'-approach regarding prohibited subsidies endorsed by the Arbitrator in *US – Upland Cotton*.[1359]
The level of countermeasures should correspond[1360] to the degree (quantitative element) and nature (qualitative element; i.e., the specific type of adverse effects) of the adverse effects as

[1355] Emphasis added. See also Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 236.
[1356] Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 237.
[1357] This interpretation is based on the wording 'maintaining' in Article 7.8 of the SCM Agreement and on the argument that implementation could easily be circumvented by replacing old subsidies with new ones if only past subsidies would be covered. Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 238. The Appellate Body also drew a parallel with the withdrawal of prohibited subsidies as well as with CVDs investigations. In the latter case, even though CVD determination is based on 'the injury determined to exist in the past, the remedial measures are prospective'. Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, paras 238-239.
[1358] Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, paras 3.18-3.20.
[1359] The only difference between both sets of countermeasures seems that arbitrators would have more flexibility to round up in case of prohibited subsidies. Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, para 4.55.
[1360] Exact or precise equality is not required. Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, para 4.39.

they present themselves in the case at hand.[1361] Applied to the *US – Upland Cotton* case, the level of countermeasures was assessed in relation to the findings of significant price suppression (Article 6.3(c) of the SCM Agreement). In this regard, the Arbitrator held that not only the portion of price suppression resulting from subsidization that renders it 'significant' is hereby captured but the entirety of price suppression.[1362] The same Arbitrator also emphasized that only the impact upon the complaining Member and not upon the rest of the world should be considered.[1363]

In sum, the level of countermeasure has to correspond to the adverse effects caused to the complaining WTO Member. This implies that arbitrators cannot avoid quantification of the adverse effect caused by subsidization, which should be done sufficiently precise that corresponding countermeasures could be decided on.[1364] To calculate the adverse effects upon Brazil of challenged US domestic cotton subsidies (i.e., marketing loans and countercyclical payments), the Arbitrator in *US – Upland Cotton* simulated a counterfactual situation involving the permanent removal of these subsidies. This would give an indication of what the world price and output levels would have been in case subsidies would have been removed and the compliance rulings would have been implemented. A similar counterfactual analysis based on economic modeling has been suggested by several economists to properly conduct the causality determination under the 'serious prejudice'-test (Article 6.3 of the SCM Agreement).[1365] As explained above, the Appellate Body in *US – Upland Cotton (Article 21.5 – Brazil)* has likewise emphasized the relevance of such economic modeling to decide on a

[1361] Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, paras 4.40-4.48. The clear difference in the wording with Article 4.10 of the SCM Agreement (prohibited subsidies) confirmed to the Arbitrators that 'the terms of Article 7.9 (…) are intended to closely tailor, in all cases, the countermeasures to the legal basis for the underlying findings'. Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, paras 4.55.

[1362] Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, paras 4.98-4.107. The Arbitrator drew a correct parallel with the imposition of CVDS, which can only be imposed if subsidization is above a *de minimis* level (is below) but a positive determination thereof does not affect the level of CVDs that can subsequently be imposed. Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, para 4.107.

[1363] See also Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, paras 4.80-4.92.

[1364] As the US observed, this task is more demanding to the Arbitrator than at the panel and Appellate Body level: 'the Arbitrator is asked to attach a number to the alleged significant price suppression caused by marketing loan and countercyclical payments. Before, the question of significant price suppression could be answered in one word: either "yes" or "no". But the question for the Arbitrator is different, and more challenging'. *United States – Subsidies on Upland Cotton* (WT/DS267) – *Arbitration under Article 22.6 of the DSU and Article 7.10 of the SCM Agreement*, Oral Statement of the United States (3 March 2009), para 10.

[1365] See Vandenbussche, above n 1239, at 211-217; Steinberg and Josling, above n 1153, at 391-392 and 402-408 It fits to the 'but for' interpretation of the causation standard under Article 6.3 of the SCM Agreement. Sapir and Trachtman questioned the use of such calibrated models, but, at the same time, did not want to over-estimate the fact that these models are not tested. See Sapir and Trachtman, above n 1195, at 183-209, at 201-205.

'serious prejudice'-claim.[1366] For this reason as well, the Arbitrator's quantification conducted in *US – Upland Cotton* deserves some further discussion.

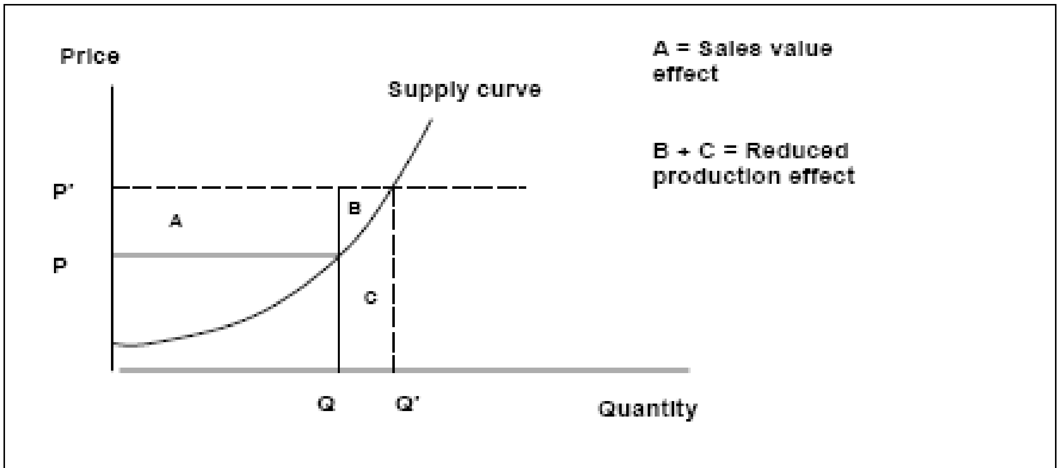


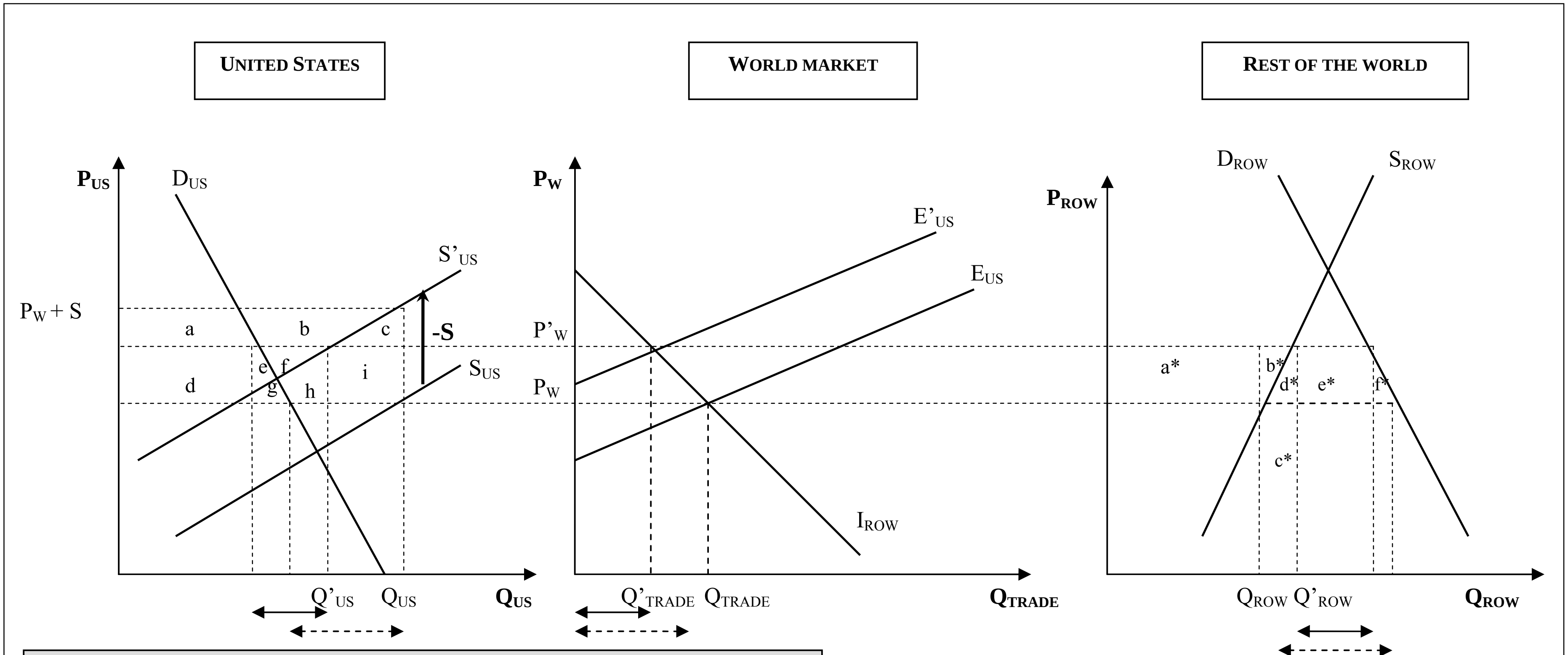
FIGURE 3: ADVERSE EFFECTS ON PRODUCERS IN THE REST OF THE WORLD[1367]

Figure 3 was advanced by Brazil as a graphically illustration of the adverse effects caused by the challenged US domestic cotton subsidies on producers in the rest of the world.[1368] The supply curve of a cotton producing country in the rest of the world is depicted and the US is considered a 'large country' in the production of cotton since changes in its output levels affect the world price of cotton (significant price suppression on the *world* market). With the US domestic subsidies in place (i.e., the actual situation), the world price is at P and Q is the quantity produced by the cotton producing country in question. Without the US subsidies (i.e., the counterfactual situation), the world price would be higher (P'; Figure 3), which would induce the producing country in question to produce more cotton (Q'; Figure 3). On this basis, Brazil disentangled two types of adverse effects caused by the suppression of the cotton world market price, namely a so-called 'sales value effect' (A; Figure 3) and 'reduced production effect' (B + C; Figure 3). In this respect, the Arbitrator accurately observed that the sum of both effects is larger than the total negative effect on producer welfare in the rest of the world.[1369] Indeed, the loss in 'producer surplus' in the actual situation (i.e., subsidy situation) is represented by the sum of the areas A and B. Area A represents the loss of selling the actual level of cotton (Q; Figure 3) at a suppressed price (P; Figure 3) and area B represents the loss of not producing an additional quantity of cotton (Q' - Q; Figure 3). Area C, on the other hand, represents the opportunity cost of the resources that would be needed to produce such additional quantity of cotton (Q' - Q; Figure 3). In the actual situation (i.e.,

[1366] See above Part II, Chapter 4, Section 4.2.3.2.2.3.
[1367] This figure was presented by Brazil in the Arbitration procedure and included in the final report. Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, para 4.128.
[1368] These covered marketing loans and countercyclical payments.
[1369] See above Part I, Chapter 1.

subsidy situation), these resources are employed elsewhere in the economy and therefore do not represent a cost to the rest of the world. Hence, the adverse effects calculated by Brazil were larger than the loss in producer welfare. Importantly, the Arbitrator accepted that adverse effects may have a wider meaning than producer surplus and found support thereto in the text of Article 6.3(c) of the SCM Agreement, in particular in its reference to 'lost sales'.[1370] Notice that the effect on consumer welfare is not considered relevant at all since the focus of Part III on actionable subsidies is confined to adverse effects on foreign *producers*. Under the perfect market assumption, the overall benefit to foreign consumers' welfare resulting from the suppressed cotton price would be larger than the loss upon foreign producers' welfare (A + B; Figure 3). This could also be seen in Figure 4, in which the information of Figure 3 is integrated in the right hand side.[1371]

[1370] Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, para 4.129. Yet, the 'lost sales' concept rather seems to be an alternative type of adverse effects under Article 6.3(c) of the SCM Agreement.
[1371] The change in welfare to the rest of the world is the sum of the changes in consumer surplus (+a*, +b*,+d*,+e*,+f*; Figure 4) and producer surplus (-a*,-b*; Figure 4) and is thus positive (+d*,+e*,+f*; Figure 4). Observe that areas c* and d* in Figure 4 (which are depicted as area C in Figure 3) are not part of the producer welfare calculus.



S = subsidy per unit output = $\dfrac{\text{marketing loan subsidies + (0.4 x countercyclical payments)}}{Q_{US}}$

Trade level between US and ROW with subsidy = Q_{TRADE} (◄- - - - - - ►)

Trade level between US and ROW after removal subsidy = Q'_{TRADE} (◄——►)

'Adverse effects' to ROW from subsidy = +a*, +b*, +c*, +d* = \$2.905 billion

World price with subsidy = P_W

World price after removal subsidy = P'_W

% Δ price in case removal = 9.38%

Δ Total welfare $_{WORLD}$ in case removal = +c, +f, +h, +i, - d*, -e*, -f* > **0**

FIGURE 4: EFFECT OF REMOVAL OF US DOMESTIC COTTON SUBSIDY

Turning to the effective calculation of the adverse effects (+A, +B, +C in Figure 3; +a*, +b*,+c*,+d* in Figure 4), the Arbitrator agreed with the use of a demand and supply log-linear displacement model proposed by Brazil. This would quantify percentage changes (e.g., in the world market price) from an initial baseline equilibrium in which all cotton subsidies are in place. Both parties, however, fundamentally disagreed on the value of key parameters to be used in the model.[1372] Evidently, Brazil defended parameters that maximized the adverse effect resulting from US subsidization (+A, +B, +C in Figure 3; +a*, +b*,+c*,+d* in Figure 4), whereas the US took the opposite view. Their difference in arguments could be illustrated on the basis of Figure 4, which disentangles the effect of the removal of US subsidization on the US market and the rest of the world. E_{US} represents the actual US export curve of cotton (with the initial world equilibrium price P_W and output Q_{TRADE}) and E'_{US} represents the counterfactual situation in which US domestic subsidies are removed. The removal of challenged US domestic cotton subsidies would thus shift the US supply curve upward (from S_{US} to S'_{US}), generating also a shift in the US export supply curve (from E_{US} to E'_{US}). Hence, a new equilibrium would emerge with a higher world market price (P'_W) and lower trade level between the US and the rest of the world (Q'_{TRADE}).

A preliminary question was the choice of the reference period to conduct this counterfactual analysis. Obviously, this was not a trivial question given that not only the level of subsidies but also their impact could, as the Arbitrator recognized, very well vary over time depending on economic or other factors. Brazil, on the one hand, proposed marketing year (MY) 2005 as this marked the end of the implementation period, whereas the US suggested that average prices of the last three years (MY 2005-2007) would be more representative. Both parties had a clear interest in suggesting their respective reference period because the cotton price was much higher in the MY 2006 and 2007 than in MY 2005, which implied *inter alia* that countercyclical payments were lower in the latter two years. The Arbitrator agreed with Brazil that the end of the implementation period is in ‘principle legitimate’, certainly in this case because the price in MY 2005 corresponded to the prices covered by the findings of the panels.[1373] Hence, MY 2005 was taken as reference period, even though it should be noted that the objective according to the Arbitrator is to fix an amount of countermeasures that corresponds to ‘the actual continued adverse effects of the measure’ in the future.[1374] In

[1372] The Arbitrator observed that the US also employed the same model but only disagreed on the used parameters and that the compliance panel had used the simulations of the model to support its finding. See Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, paras 4.130-4.134.
[1373] Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, para 4.118.
[1374] Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, para 4.117.

principle, countermeasures should therefore not correspond to the level of adverse effects under the *past* period covered by the panel proceedings.

With regard to the parameters to be included in the model, Brazil proposed numbers that maximized the adverse effects of subsidization in MY 2005, whereas the US adduced arguments for the opposite. A pivotal element was the value of the different supply and demand elasticities, which indicate the responsiveness of respectively production and demand to a change in price. The higher the elasticity, the greater the percentage increase (decrease) in cotton supply (demand) for a given increase in the world price of cotton. The Arbitrator accorded with Brazil to use short-term elasticities – which are relatively more inelastic – as this recognized that consumers as well as producers in the rest of the world would incur adjustment costs when subsidies would be removed.[1375] As it would take time for consumers and producers to fully adjust to the removal of subsidies and these adjustment costs were partly due to subsidization itself (e.g., the low world price induced low investment levels), the use of short-term elasticities was considered appropriate.[1376] Next, the Arbitrator also agreed with all Brazil's suggested elasticities, which were relatively (i.e., compared to the US figures) *inelastic* for US demand (D_{US}; Figure 4), the 'rest of the world'-demand (D_{ROW}; Figure 4), supply in the rest of the world (S_{ROW}; Figure 4) but *elastic* for US supply (S_{US}; Figure 4).[1377] Hence, in case of removal of US domestic subsidies, the market would, in relative terms, respond as follows: US producers would largely cut back their level of production due to the lower price they receive ($P'_W < P_W + S$; Figure 4), whereas total demand as well as supply in the rest of the world subsidies would in the short run only moderately react to the higher world market price (P'_W; Figure 4) by, respectively, decreasing consumption and increasing production. The Arbitrator had found support in the economic research for Brazil's proposed elasticities, though it admitted that 'this is not by any means overwhelming'.[1378] Next to elasticities, another important parameter was the coupling factor,

[1375] The Arbitrator defined the long-run and short-run as follows:

> 'The long-run essentially refers to a situation where all adjustments by producers, consumers, and owners of factors of production to the given change have been completed and the market has settled down to a (long-run) equilibrium. The short-run refers to a situation, which could be one of (short-run) equilibrium, where the process of adjustment by producers, consumers and owners of factors of production has not been fully completed. This less than complete adjustment in the economy may be the result of certain rigidities in the market or simply that it takes time for producers to re-allocate resources'.

Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, para 4.144.

[1376] See Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, paras 4.144-4.147.

[1377] This is illustrated in Figure 4 by depicting relatively steep curves for D_{US}, D_{ROW} and S_{ROW} and a relatively flat curve for S_{US}. The proposed elasticities of respectively Brazil and the US were: D_{US} (-0.20, -0.82); D_{ROW} (-0.20,-0.39); S_{ROW} (0.20, 0.33); S_{US} (0,80, 0.21).

[1378] Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, para 4.162.

which refers to the production stimulation effect that a subsidy has relative to revenue from the market.[1379] Although the Arbitrator acknowledged that there was 'hardly any econometric evidence' estimating the coupling factor for countercyclical cotton payments, it again accorded with Brazil's suggested coupling factor.[1380] Finally, it was considered relevant that farmers' production decisions are based on expectations on the cotton price at the end of the year.[1381] Given that subsidy amounts also varied with the cotton price, expectations on cotton prices triggered expectations on the level of subsidies that would be received. Because statistical analysis showed that forecasts based on future cotton prices, as suggested by the US, were more accurate than those based on lagged prices, as proposed by Brazil, the Arbitrator opted for the inclusion of future cotton prices in the model.[1382]

On the basis of these parameters (i.e., elasticities, coupling factor, price expectations), the Arbitrator rerun the log-linear displacement model and found that the world price would have been higher by 9.38% in the counterfactual 'no-subsidy'-situation. Furthermore, total adverse effects of those subsidies in MY 2005 on the rest of the world (+A, +B, +C in Figure 3; +a*, +b*,+c*,+d* in Figure 4) were estimated on $2.905 billion.[1383] Given that Brazil's share of cotton production in the rest of the world was 5.1% in MY 2005, the level of countermeasures considered commensurate with the degree and nature of adverse effects upon Brazil was determined on $147.3 million.[1384]

This Arbitrator's decision in *US – Upland Cotton* offers an interesting example on how economic models could be used to quantify the trade effects of subsidization. This enabled

[1379] Countercyclical payments were decoupled from actual production levels. Instead, such payments were based on historical base area and historical programme yield. Contrary to the other type of domestic subsidies (i.e., marketing loans), one extra dollar of subsidies in the form of countercyclical payments therefore generated a lower production incentive than a dollar rise in the market price, implying that its coupling factor is lower than one.

[1380] Brazil proposed a coupling factor of 0.4, which was evidently higher than the figure suggested by the US (0.25). A relatively high coupling factor would graphically be reflected in a large upward shift in the US supply curve (from S_{US} to S'_{US}; Figure 4) in case of removal of the cotton subsidies. Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, paras 4.164-4.178.

[1381] Cotton production decisions are made in the beginning of the calendar year but marketing only starts at the end of the year.

[1382] The Arbitrator requested the parties to provide the root mean square error (RMSE) of their forecasts, and this was lower if future prices were used. Another reason for accepting expectations about future prices was that the one-year lagged prices are not known at the moment farmers make their production decision. See Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, paras 4.186-4192.

[1383] This consisted of a sales value effect (+A in Figure 3; +a* in Figure 4) of $2.384 billion and reduced production effects (+B, +C in Figure 3; +b*,+c*,+d* in Figure 4) of $521.5 million. See Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, para 4.193.

[1384] See Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, para. 4.195. Recall that the Arbitrator had decided that only the amount of adverse effects upon the complaining party should be taken into consideration for determining the level of countermeasures.

the Arbitrator to figure out that the price suppressing effect of US cotton subsidies amounted to nearly 10 per cent. As mentioned above, several scholars have called for the use of such economic modeling to establish the causation element under the 'serious prejudice' threshold of Article 6.3 of the SCM Agreement.[1385] In light of this plea, two relevant aspects of the Arbitrator's decision should be highlighted in conclusion.

First, the model used by the Arbitrator is what is called by economists a 'calibrated model', in which specific assumptions are made about the equilibrium process that links these variables in a specific way, without empirically testing their validity.[1386] Although the basic characteristics of the model could therefore be questioned, the Arbitrator was confident to rely on the demand and supply log-linear displacement model proposed by Brazil because the US had likewise employed this model (with its own set of parameters) and the compliance panel had used simulations of the model to support its findings.[1387]

Second, the parameter choice (e.g., elasticities, coupling factor, price expectations) included in the model was, as illustrated above, subject to strong disagreement among the parties. Importantly, the economic studies on which both relied widely varied in their calculations of these parameters. For example, the adverse effects upon Brazil on the basis of US calculations in the same model were five times smaller than the Arbitrator's figure ($30.4 million instead of $147.5). Overall, the Arbitrator relied on Brazil's values, not so much because economic studies were on average in line with those values, but because the use in *some* studies of these values implied that they were not inappropriate.[1388] Although the Arbitrator held that there was less flexibility to calculate countermeasures under actionable subsidy than prohibited subsidy claims,[1389] the parameters proposed by the complaining member were still accepted as long as it was not demonstrated that they were inappropriate or inadequate. On the other hand, the burden of making a *prima facie* case under Article 6.3 of the SCM Agreement rests on the complaining Member. This suggests that less leeway will be given to the parameters proposed by the complaining party. At the same time, the standard under Article 6.3 of the SCM Agreement only requires that price suppression is 'significant', which might very well be the case also on the basis of the defendant's parameters. For

[1385] See above n 1365.

[1386] For this reason, Sapir and Trachtman have questioned the results of the calibrated model presented to the compliance panel because such model *assumes* that there is a positive relationship between US subsidies and the world cotton price. Sapir and Trachtman, above n 1195, at 204-205.

[1387] See Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 10.222; Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, paras 4.132-4.133.

[1388] For example, the Arbitrator determined that the coupling factor as proposed by Brazil 'is within the range found in the relevant literature and is not inappropriate'. See Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, paras 4.119, 4.147, 4.163, 4.178.

[1389] Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – United States) (actionable subsidies)*, para 4.55.

instance, the Appellate Body in *US – Upland Cotton (Article 21.5 – Brazil)* considered that the range of price effects resulting from all simulations would fall within the Panel's view of what constitutes *significant* price suppression.[1390]

5.1.3.3. Non-actionable subsidies

Although non-actionable subsidies were allowed until the end of the 1999s, the SCM Agreement provided a limited multilateral remedy to other WTO Members to challenge such green light subsidies if they caused '*serious* adverse effects' to their domestic industry.[1391] Hence, the burden of proof upon the complaining party was higher than in the case of actionable subsidies (referring to 'adverse effects'). If consultations failed, it was up to the SCM Committee, and thus not a panel, to decide on whether this burden was met.[1392] The SCM Committee could 'recommend' modifying the programme in such a way as to remove these effects. If the recommendations were not followed within six months, the SCM Committee could authorize countermeasures 'commensurate with the nature and degree of the effects determined to exist'.[1393]

5.2. UNILATERAL REMEDIES: COUNTERVAILING MEASURES

Instead of following the multilateral avenue described above, a WTO Member is allowed to opt for the unilateral approach and to levy countervailing duties (CVDs) on imported products for the purpose of offsetting specific subsidies bestowed on the manufacture, production or export of those goods.[1394] Yet, the SCM Agreement also disciplines this unilateral avenue. CVDs may only be imposed pursuant to an investigation in accordance with the procedural and substantive obligations stipulated in Part V of the SCM Agreement. Hence, Part V of the SCM Agreement aims 'at striking a balance between the right to impose countervailing duties to offset subsidization that is causing injury, and the obligations that Members must respect in order to do so'.[1395] To correctly impose CVDs measures, the CVDs investigation has to be conducted in conformity to the specific procedural disciplines and should reach a positive determination of three substantive elements: (1) the existence of a specific subsidy, (2) injury

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[1390] Appellate Body Report, *US – Upland Cotton (Brazil – Article 21.5)*, paras 365, 435. See above Part II, Chapter 4, Section 4.2.3.2.2.3.
[1391] Article 9.1 of the SCM Agreement (emphasis added).
[1392] Article 9.3 of the SCM Agreement.
[1393] Article 9.4 of the SCM Agreement.
[1394] See Appellate Body Report, *US – Carbon Steel*, para 73; Panel Report, *US – Countervailing Measures on Certain EC Products*, para 7.41. See Articles 10 (footnote 36), 19.1 of the SCM Agreement and Article VI:3 of the GATT. The Panel in *US – Countervailing Measures on Certain EC Products* underlined that CVDs are thus not designed 'to counteract all market distortions or resource misallocations which might have been caused by subsidization'. Panel Report, *US – Countervailing Measures on Certain EC Products*, paras 7.42, 7.80.
[1395] Appellate Body Report, *US – Carbon Steel*, para 74.

to the domestic industry producing the like product, and (3) a causal link between the subsidized import and the injury. The specific procedural obligations set out in the SCM Agreement are examined first.

5.2.1. Procedural requirements

The basic thrust of the procedural disciplines is to ensure that the CVDs investigation is conducted in an objective manner, in which equal opportunity is given to different stakeholders to present their opposing interests. This requirement of 'due process' is explicitly stipulated with regard to the injury determination. Indeed, by virtue of Article 15.1 of the SCM Agreement, the investigating authority has to make an 'objective examination' of the matter. The Panel in *EC – Countervailing Measures on DRAM Chips* clarified that this standard 'requires that the domestic industry, and the effects of (subsidized) imports be investigated in an unbiased manner, without favoring the interests of any interested party, or group of interested parties, in the investigation'.[1396] A key question is, however, which stakeholders are formally recognized as interested parties. Surely, not only private parties but foreign governments as well are involved in the investigation as subsidization is in essence a governmental act. Before going into these 'due process' requirements regarding other WTO Members and private interested parties, the disciplines on the initiation and duration of CVDs investigations are spelled out.

5.2.1.1. Initiation and duration

An investigation can be initiated either by or on behalf of the domestic industry or by the authorities of their own accord.[1397] It is made 'by or on behalf of the domestic industry', if the petition is supported by domestic producers whose collective output accounts for more than 50 per cent of total production of the like product produced by that portion of the domestic industry that expressed its view, either for or against. If, however, domestic producers supporting the petition account for less than 25 per cent of total domestic production of the like product, national authorities may not initiate an investigation.[1398] Thus, to prevent that the CVDs procedure is captured by the interests of some producers, a sufficient number of

[1396] Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.274. The Panel paraphrased the Appellate Body in *US – Hot-Rolled Steel*, para 193.
[1397] Articles 11.2 and 11.6 of the SCM Agreement.
[1398] Article 11.4 of the SCM Agreement (similar to Article 5.4 of the Anti-Dumping Agreement). The rationale of the domestic producers that elect to support an investigation is considered irrelevant. See Appellate Body Report, *US – Offset Act (Byrd Amendment)*, paras 283 and 291.

domestic producers must have expressed support for the application.[1399] Only 'in special circumstances' can the authorities decide to initiate an investigation without an application by or on behalf the domestic industry.[1400]

The written application by the domestic industry should contain *sufficient evidence* of the existence of the three substantive elements: a subsidy, injury, and a causal link injury.[1401] The authorities have to review the accuracy and adequacy of this evidence to determine whether the evidence is sufficient to justify the initiation of an investigation. In parallel, the investigation can be initiated *ex officio* only if the authorities have sufficient evidence on the three substantive elements, whereby 'sufficient' means there is probable cause for an investigation.[1402] As a consequence, an application to investigate should be rejected and an investigation should be terminated as soon as the authorities are satisfied that there is not sufficient evidence of either subsidization or injury. It should be terminated (i) when the amount of the subsidy is *de minimis*, which is the case if it is less than 1 per cent ad valorem, or (ii) where the volume of the subsidized imports or the injury is 'negligible', but this concept is not defined.[1403] Note already that this threshold is higher in case CVDs are initiated against developing countries.[1404] If an investigation is launched, it should normally be concluded within one year. In 'special circumstances', however, it should only be concluded within 18 months after its initiation (Article 11.11 of the SCM Agreement). As the Panel in *Mexico – Olive Oil* rightly explained, Article 11.11 is 'clear and unequivocal' and leaves no room 'to prolong an investigation beyond 18 months for any reason, including requests from interested parties'.[1405] Within this well-defined period, the investigating authority that considers imposing CVDs has to demonstrate the existence of a subsidy causing injury to its domestic industry.[1406]

5.2.1.2. Consultation of alleged subsidizing WTO Member

The pivotal difference between anti-dumping procedures and CVDs procedures is that the former strictly targets private behaviour, whereas the latter also inevitably has to scrutinize foreign governments' conduct as part of the subsidy analysis. This makes CVDs action much more sensitive politically and partly explains why this instrument is used far less frequently

[1399] The definition of 'like product' is pivotal to apply the thresholds set by Article 11.4 of the SCM Agreement. Footnote 46 of the SCM Agreement defines the concept of 'like product' in the context of the SCM Agreement (see also below Part II, Chapter 5, Section 5.2.2.2.4).
[1400] Article 11.6 of the SCM Agreement.
[1401] Article 11.2 of the SCM Agreement.
[1402] Matsushita, Schoenbaum, and Mavroidis, above n 721, at 289.
[1403] Article 11.9 of the SCM Agreement.
[1404] Article 27.10 of the SCM Agreement. See below Part II, Chapter 6, Section 6.1.3.
[1405] Panel Report, *Mexico – Olive Oil*, paras 7.120-7.123.
[1406] Article 19.1 of the SCM Agreement. See below Part II, Chapter 5, Section 5.2.2.

than anti-dumping duties.[1407] Likewise, it explains the main difference between both sets of procedures: 'due process' requirements in CVDs procedures with regard to foreign governments are more extensive. The consultation requirement is, for instance, specific to the CVDs investigation.

By virtue of this requirement, WTO Members the products of which may be subject to the investigation should be invited for consultation by the investigating authority as soon as possible after an application is accepted and before the formal initiation of the investigation.[1408] Moreover, throughout the period of investigation, those WTO Members shall be afforded a reasonable opportunity to continue consultations with a view to clarifying the situation and to arriving at a mutually agreed solution.[1409] At the same time, this obligation to 'afford reasonable opportunity for consultation' is not intended to prevent the investigating authority from proceeding 'expeditiously' with the various steps of the procedure.[1410] Next to this consultation requirement, the targeted WTO Members are also involved in the gathering of evidence, which is discussed in the following section.

5.2.1.3. Gathering of evidence

5.2.1.3.1. Due process rights in the gathering of evidence

Article 12 of the SCM Agreement provides for specific 'due process' rights on the gathering of evidence, in particular for interested WTO Members as well as 'interested parties'.[1411] First, both should be given the opportunity to present all evidence that they consider relevant.[1412] To prepare their case, they should also be provided timely opportunities to see all relevant non-confidential information used in the investigating.[1413] Second, before the final determination, the investigating authorities have to inform them of the essential facts that form the basis for their decision whether to apply definitive measures. This disclosure should take place 'in sufficient time' for these parties to defend their interest.[1414]

[1407] See Mavroidis, Messerlin, and Wauters, above n 721, at 375.
[1408] Article 13.1 of the SCM Agreement. The term 'initiated' means 'procedural action by which a Member formally commences an investigation as provided in Article 11' (footnote 37 of the SCM Agreement). Hence, the date of initiation is according to the Panel in *Mexico – Olive Oil* based 'on the internal law of the importing Member'. Panel Report, *Mexico – Olive Oil*, paras 7.22-7.31.
[1409] Article 13.2 of the SCM Agreement.
[1410] Article 13.3 of the SCM Agreement.
[1411] Article 12 of the SCM Agreement. See also Appellate Body Report, *Mexico – Anti-Dumping Measures on Rice*, para 292; Appellate Body Report, *EC – Tube or Pipe Fittings*, para 138.
[1412] For details, see Article 12.1 of the SCM Agreement. This could, upon justification, also be done orally, though this should subsequently be reduced to written submissions. Article 12.2 of the SCM Agreement.
[1413] Articles 12.1.2, 12.3 and 12.4 of the SCM Agreement.
[1414] Article 12.8 of the SCM Agreement.

According to Article 12.9 of the SCM Agreement, 'interested parties' include at least:

> (i) the exporter, foreign producer or importer of the product subject to the investigation (…);
> (ii) the domestic producer of the like product in the importing Member (…).[1415]

However, this list does 'not preclude Members from allowing domestic or foreign parties other than those mentioned above to be included as interested parties' (Article 12.9 of the SCM Agreement). To be recognized as interested party under this residual category, no formal request by the party in question is required according to the Appellate Body in *Japan – DRAMs (Korea)*.[1416] What is more, a party could be designated as 'interested party' even if this is not in its own interest but in the interest of the investigating authority.[1417] Although an investigating authority does not 'enjoy an unfettered discretion', it needs in the Appellate Body's view:

> (…) to have some discretion to include as interested parties entities that are relevant for carrying out an objective investigation and for obtaining information or evidence relevant to the investigation at hand. Nonetheless, in designating entities as interested parties, an investigating authority must be mindful of the burden that such designation may entail for other interested parties.[1418]

Hence, Japan's investigating authority was allowed to designate a number of private creditors of Hynix as 'interested party' even if they had not expressed any interest in the outcome of the investigating. After all, information in their hands was considered relevant to determine whether they were entrusted or directed by the Korean government to provide credit to Hynix (i.e., the subsidy determination).

The two listed types of 'interested parties' (i.e., foreign and domestic producers),[1419] with their opposing interests, are thus put on an equal footing in the gathering of evidence. On the other hand, domestic consumers (i.e., industrial users of the investigated product or representative consumer organizations when the product is sold at retail level) are not explicitly mentioned as interested parties. This reflects the bias toward producer welfare in the SCM Agreement. Obviously, domestic consumers share the same interest as foreign

[1415] See Article 12.9 of the SCM Agreement.
[1416] Appellate Body Report, *Japan – DRAMs (Korea),* paras 239-240.
[1417] After all, the Appellate Body read the term 'allowing' in Article 12.9 of the SCM Ageeement as connoting to 'the power or authority given to a Member to include other parties as interested parties, rather than a restriction on such power of inclusion to those parties that make a request' (Appellate Body Report, *Japan – DRAMs (Korea),* para 240). Yet, it has been suggested by scholars (e.g., Benitah) that the term 'allowing' connotes to the right given to parties to be included as interested party by the investigating authority rather than to the power given to investigating authority to include them. Moreover, the ordinary meaning of 'interested party' seems to connote to an interest on the part of the party itself and not on the part of the investigating authority.
[1418] Appellate Body Report, *Japan – DRAMs (Korea)*, para 242.
[1419] Exporters and importers of the product under investigation share the same interest as foreign producers and are likewise listed.

producers since they benefit from the depressed/suppressed price and would be hurt by the imposition of CVDs.[1420] Under the SCM Agreement, industrial users and representative consumer organizations should only be given the opportunity to provide relevant information (Article 12.10 of the SCM Agreement; see below). In additional, WTO Members are free to give them the status of 'interested party' in an investigation (Article 12.9 of the SCM Agreement).

5.2.1.3.2. Evidentiary standard

According to Article 12.2 of the SCM Agreement, any decision of the investigating authority should be based on information and arguments on its written record that were available to interested Members and interested parties (except for confidential information). Unless otherwise specified in the SCM Agreement, any decision of the investigating authority should therefore only 'be based on' on evidence on the agency's record and no particular higher standard should be adhered to.[1421] For instance, the investigating authority does not have to offer 'positive evidence' of government entrustment/direction under Article 1.1(a)(1)(iv) of the SCM Agreement.[1422] In contrast, such a specific standard of 'positive evidence' is explicitly prescribed for findings of specificity as well as injury by virtue of Articles 2.4 and 15.1 of the SCM Agreement, respectively.[1423]

To verify the accuracy of the supplied information or to gather evidence, the investigating authority may carry out investigations in the territory of the WTO Member under investigation or in other Members if this is notified in good time and those Members do not object to the investigation.[1424] Similarly, investigations may be carried on the premises of a firm (or its records) if the firm so agrees and the WTO Member is notified and does not object. Even though the WTO Member and firms under investigation are in principle free to block such on the spot investigations, failure to participate may incur the negative consequence that the investigating authority could ground its decision on the 'facts available'.[1425]

Indeed, if an interested Member or interested party does not provide necessary information or significantly impedes the investigation, investigating authorities are allowed to make

[1420] See above Part I, Chapter 1.
[1421] Article 12 of the SCM Agreement. Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 138.
[1422] See, for example, Panel Report, *Japan – DRAMs (Korea)*, para 7.81.
[1423] Concerning the specificity element, see above Part II, Chapter 3, Section 3.3.3.
[1424] Article 12.6 of the SCM Agreement. See also Panel Report, *US – Countervailing Duty Investigation on DRAMS*, para 7.404.
[1425] Insofar they are interested Member or interested party. See also Panel Report, *US – Countervailing Duty Investigation on DRAMS*, para 7.406.

determinations on the basis of the facts that are available.[1426] Intended to ensure that such cooperation failure 'does not hinder an agency's investigation', this provision permits an 'investigating authority, under certain circumstances, to fill in gaps in the information necessary to arrive at a conclusion as to subsidization (…) and injury'.[1427] An investigating authority could thus take resort to the facts available to fill in gaps in case of a lack of cooperation of an interested Member or interested party.[1428] At the same time, the Appellate Body emphasized that such a determination on 'the facts available' does not permit the investigating authority to 'use any information in whatever way it chooses'.[1429] First, it must take into account all substantiated facts provided by an interested party, even if those facts may not correspond to the complete requested information. Second, 'facts available' are generally limited to those that may 'reasonably replace the information that an interested party failed to provide', which in certain circumstances may include information from secondary sources.[1430] For instance, the Panel in *EC – Countervailing Measures on DRAM Chips* had agreed with the EC's use of press reports as secondary source of information for its subsidy determination because of a lack of cooperation on the part of Korea. Importantly, non-cooperation thus only makes it possible to rely on other facts that are available and 'by itself does not suffice to justify a conclusion which is negative to the interested party that failed to cooperate with the investigating authority'.[1431] The determination still has to be made on 'the basis of the available *facts*, and not on mere speculation'.[1432]

This right upon the investigating authority to base a determination on the 'facts available' explains why Japan included private creditors of Hynix as 'interested parties' in its investigation and why this was challenged by Korea in *Japan – DRAMs (Korea)*. After all, the status of 'interested party' not only gives this party the right to present evidence but, in turn, gives the investigating authority a right to base its determination on the 'facts available' when this 'interested party' fails to participate in the investigation. Article 12.7 of the SCM Agreement only allows such determination in case an 'interested Member' or 'interested party' fails to participate. In most cases, the relevant information to make a determination of

[1426] Article 12.7 of the SCM Agreement.
[1427] Appellate Body Report, *Mexico – Anti-Dumping Measures on Rice*, paras 291, 293; see also Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.61; Panel Report, *Japan – DRAMs (Korea)*, para 7.392.
[1428] This is of course also the case when information is deliberately withheld. See Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.254.
[1429] Appellate Body Report, *Mexico – Anti-Dumping Measures on Rice*, paras 292-294; see also Panel Report, *US – Countervailing Duty Investigation on DRAMS*, para 7.406; Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.245.
[1430] Appellate Body Report, *Mexico – Anti-Dumping Measures on Rice*, para 294.
[1431] Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.61.
[1432] Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.61 (emphasis in the original).

the substantive elements (e.g., subsidy and injury) could be obtained from those actors listed as 'interested parties' in Article 12.9 of the SCM Agreement (e.g., foreign producer, subsidizing Member, domestic producer). However, in case of indirect subsidization, essential information is in the hands of those private bodies alleged to be entrusted/directed by the government and these actors are not explicitly listed as interested party. Hence, if they could not be designated as 'interested party' by the investigating authority, their failure to provide this essential information could not lead to a determination on the basis of other facts that are available.[1433,1434] Thus, by (overly[1435]) stretching the interpretation of the term 'interested party', the Panel and Appellate Body in *Japan – DRAMs (Korea)* prevented that private actors having relevant information but not listed as interested parties could block a CVDs investigation. Investigating authorities are thus well advised to formally designate such actors the status of 'interested party' under Article 12.9 of the SCM Agreement.

5.2.2. Substantive requirements

To impose CVDs, an investigation along the lines of the procedural requirements set out above has to arrive at a determination of the existence of a specific subsidy causing injury or threat thereof to the domestic industry.[1436] In particular, the right to impose CVDs is thus conditioned on the demonstrated existence of three substantive elements, which are discussed in turn: 'subsidization, injury, and a causal link between the two'.[1437]

5.2.2.1. Specific subsidy

As to this first element, we could refer to the discussion on the definition of a specific subsidy under Chapter 3. The investigating authority should show the existence of a financial contribution (or income/price support) by another WTO Member that confers a benefit to a specific recipient.[1438] Regarding the 'specificity' test, it should be remembered that this has to be demonstrated on the basis of 'positive evidence'.

[1433] The Panel clearly expressed this concern:

> 'the scope of the right of investigating authorities to include parties as "interested parties" in investigations must be interpreted with a view to ensuring that investigating authorities are able to obtain the "necessary information" needed to arrive at a determination' and 'this consideration carries considerable weight in cases involving entrustment or direction, where the relevant information may be held only by the third parties who have been allegedly been entrusted or directed'.

Panel Report, *Japam – DRAMs (Korea)*, para 7.392 and footnote 581.

[1434] Such failure to cooperate is not unlikely given that these private parties often do not have a direct interest in the investigation.

[1435] See above n 1417.

[1436] Articles 10, 11.2, and 19.1 of the SCM Agreement and Article VI of the GATT.

[1437] Appellate Body Report, *US – Carbon Steel*, para 73.

[1438] Regarding the specificity requirement, see Article 1.2 of the SCM Agreement, which explicitly refers to Part V of the SCM Agreement dealing with CVDs action.

The Panel in *Japan – DRAMs (Korea)* explained that the private market test under Article 1.1(b) of the SCM Agreement (i.e., benefit-determination) could be operationalized by CVDs-investigating authorities in a double way.[1439] An investigating authority could gather evidence of the terms that the market would have offered and compare these with the terms of the financial contribution at issue. Alternatively, or additionally, an investigating authority might rely on evidence of whether or not the financial contribution was provided on the basis of non-commercial considerations. Under both approaches, it would be revealed whether the financial contribution was made at commercially reasonable terms. In case the outcome of both types of evidence would conflict, the CVDs-investigating authority would need to compare their probative value.[1440]

Because the level of CVDs cannot be above the subsidy level, a CVDs-investigating authority should not only demonstrate the *existence* of a benefit but likewise has to *quantify* its level.[1441,1442] To this end, Article 14 of the SCM Agreement sets guidelines for calculating the subsidy amount in terms of the benefit to the recipient.[1443] The Appellate Body distinguished three requirements in the chapeau of Article 14 of the SCM Agreement: (1) 'any method used' for the calculation should be provided for in the national legislation or implementing regulations; (2) the application of that method in each particular case has to be transparent and adequately explained; and (3) 'any such method' shall be consistent with the guidelines contained in paragraphs (a)-(d).[1444,1445] Analyzing the procedural requirements, the Appellate Body concluded that Article 14 leaves WTO Members 'some latitude' as to the method it chooses to calculate the benefit amount.[1446] It is not required that the method used in a particular case is set out in detail but only that it can be 'derived from, or is discernable from, the national legislation or implementing regulations'.[1447] On substance, paragraphs (a)-(d) of

[1439] Panel Report, *Japan – DRAMs (Korea)*, para 7.276.
[1440] Panel Report, *Japan – DRAMs (Korea)*, para 2.276, footnote 475.
[1441] Recall that such exact quantification is not necessary in a multilateral 'serious prejudice' claim. In a multilateral claim, quantification will only be conducted when countermeasures are calculated as a result of non-implementation. See also Appellate Body Report, *US – Upland Cotton*, para 464.
[1442] This might also mandate a 'pass-through' analysis in case the subsidy is given to upstream producers but CVDs are imposed on imported downstream products (see above Part II, Chapter 3, Section 3.2.2.1).
[1443] As explained above, Article 14 of the SCM Agreement is also considered useful context for demonstrating the existence of a benefit under Article 1.1(b) of the SCM Agreement (see above Part II, Chapter 3, Section 3.2).
[1444] Appellate Body Report, *Japan – DRAMs (Korea)*, para 190.
[1445] These paragraphs specify guidelines in case the subsidy takes the form of, respectively, (a) the government provision of equity capital, (b) a government loan, (c) a government loan guarantee, or (d) the provision of goods and services or purchase of goods by the government. The Panel in *Japan – DRAMs (Korea)* indicated that 'the Article 14 guidelines do not cover all eventualities'. See Panel Report, *Japan – DRAMs (Korea)*, para 7.275.
[1446] Appellate Body Report, *Japan – DRAMs (Korea)*, para 191.
[1447] Appellate Body Report, *Japan – DRAMs (Korea)*, para 192.

Article 14 of the SCM Agreement define a benefit by reference to the terms the recipient would receive on the market to obtain the financial contribution at stake.

Obviously, not only domestic subsidies but also export subsidies can be countervailed but, again, only if causation of injury to the domestic industry is established. Instead of demonstrating the subsidy and benefit element on the basis of Article 1 of the SCM Agreement, CVDs-investigating authorities might alternatively opt for the Illustrative List. Even export subsidies that are explicitly deemed not 'prohibited' according to the Illustrative List or on the basis of S&D treatment could still be countervailed. Recall that, if it is demonstrated that subsidies are *export* subsidies (either under Article 1 *juncto* 3 of the SCM Agreement or the Illustrative List), they are deemed specific under Article 2.3 of the SCM Agreement.[1448] Whereas non-actionable subsidies were not fully safe for multilateral action, they could certainly not be countervailed even if they were not notified.[1449] Because this category was extinguished, *all* specific subsidies in the meaning of Article 1 and 2 of the SCM Agreement can be countervailed if they cause injury to the domestic industry. The injury standard is explored in the next section.

5.2.2.2. Injury or threat of injury

The SCM Agreement elaborates upon the injury provisions of Article VI of the GATT. Injury refers to 'material injury' or 'threat of material injury' to the domestic industry but these notions are not defined in more detail.[1450] The Appellate Body in *US – Lamb* stressed that the 'material injury'-standard in the SCM Agreement (and Anti-Dumping Agreement) is certainly lower than the 'serious injury'-standard for safeguard measures because CVDs (and anti-dumping measures) counteract *unfair* trade actions.[1451]

How should such (threat of) material injury be established? Article 15.1 of the SCM Agreement is the starting point for this analysis. This overarching provision 'sets forth a Member's fundamental, substantive obligation with respect to the determination of injury'[1452] and informs the more specific obligations set out in the other provisions of Article 15.[1453] Article 15.1 of the SCM Agreement stipulates that the demonstration of material injury should:

[1448] Such demonstration of 'export contingency', which is strictly speaking not needed as a condition for imposing CVDs, facilitates the demonstration of specificity.
[1449] Article 10, footnote 35 of the SCM Agreement.
[1450] Alternatively, it could likewise refer to 'material retardation of the establishment of a domestic injury'. See footnote 45 of the SCM Agreement
[1451] Appellate Body Report, *US – Lamb*, para 124.
[1452] Panel Report, *Mexico – Olive Oil*, para 7.263.
[1453] Panel Report, *Mexico – Olive Oil*, para 7.263.

> (…) be based on *positive evidence* and involve an *objective examination* of both (a) the *volume* of the subsidized imports and the *effect* of the subsidized imports on *prices* in the domestic market for like products and (b) the consequent *impact* of these imports on the *domestic producers* of such products.[1454]

The substantive requirements of the injury demonstration are thus based on a two-pronged approach related to: (a) the volume/price effect and (b) the impact on domestic producers. Before addressing these substantive requirements, the procedural obligations reflected in the 'positive evidence' and 'objective examination' concepts should be explained. Both concepts are used as steppingstone by the case law to elaborate upon some specific procedural disciplines lacking in the SCM Agreement.

5.2.2.2.1. Positive evidence and objective examination

The term *positive evidence* refers according to the Appellate Body to 'the quality of the evidence that authorities may rely upon in making a determination' and requires that such evidence must be of an 'an affirmative, objective and verifiable character, and that it must be credible'.[1455] Whereas the term positive evidence 'focuses on the facts underpinning and justifying the injury determination', the term *objective examination* is concerned 'with the investigative process itself'. Hence, the latter relates to the way in which the evidence is gathered.[1456] The qualification 'objective' means that this process should conform to the 'the basic principles of good faith and fundamental fairness', implying in particular that it should be conducted in 'an unbiased manner, without favouring the interests of any interested party, or group of interested parties, in the investigation'.[1457] This means that 'the identification, investigation and evaluation of the relevant factors must be even-handed'.[1458]

Panels and the Appellate Body have relied on these general terms to set certain limits on the discretion of investigating authorities to select the period of investigation. Such explicit disciplines are lacking in both the Anti-Dumping Agreement and the SCM Agreement. This

[1454] Footnotes deleted, emphasis added.
[1455] This is spelled out by the Appellate Body in *US – Hot Rolled Steel* in the context of Anti-Dumping (Article 3.1 of the Anti-Dumping Agreement) and applied by several panels in the context of CVDs (Article 15.1 of the SCM Agreement). Appellate Body Report, *US – Hot Rolled Steel*, para 192; Panel Report, *US – Mexico Olive Oil*, para 7.264; Panel Report, *Mexico – Steel Pipes and Tubes*, para 7.214; Panel Report, *EC – DRAMS Countervailing Measures*, para 7.272; Panel Report, *US – Countervailing Duty Investigation on DRAMS*, para 7.215; Panel Report, *US – Softwood Lumber VI*, para 7.28.
[1456] Appellate Body Report, *US – Hot Rolled Steel*, para 192.
[1457] Appellate Body Report, *US – Hot Rolled Steel*, para 192. Again, this interpretation is applied by several panels in the context of CVDs. Panel Report, *US – Mexico Olive Oil*, para 7.265; Panel Report, *Mexico – Steel Pipes and Tubes*, para 7.214; Panel Report, *EC – DRAMS Countervailing Measures*, para 7.273; Panel Report, *US – Countervailing Duty Investigation on DRAMS*, para 7.216; Panel Report, *US – Softwood Lumber VI*, para 7.28.
[1458] Appellate Body Report, *US – Hot Rolled Steel*, para 192; Panel Report, *Mexico – Steel Pipes and Tubes*, para 7.214.

selection is, nonetheless, important as it determines the data that will be used for assessing subsidization, injury, and their causal relationship.[1459] Acknowledging that the SCM Agreement indeed sets no express requirement regarding this selection, the Panel in *Mexico – Olive Oil* found that the 'positive evidence' and 'objective examination' obligations imply that an investigating authority's discretion on this matter is subject to 'certain constraints'.[1460] Two types of constraints have been spelled out in the case law. First, the same Panel decided that a *truncated* injury analysis period (i.e., parts of successive years instead of the continuous period of years) could be acceptable but only if a substantive rationale could be articulated.[1461,1462] After all, data relating to full year periods would in general give a more accurate picture of the state of the domestic industry.[1463] Second, in the context of anti-dumping, the Appellate Body has established that the use of a *remote* investigation period is not a *per se* violation of the 'positive evidence' standard but, again, a valid rationale seems to be required explaining why more recent data could not be used.[1464] Because the conditions to impose an anti-dumping duty are to be assessed with respect to the current situation, the determination of whether such current injury exists should be 'based on data that provide indications of the situation prevailing when the investigation takes place'.[1465] Historical data could be used but 'more recent data is likely to provide better indications about current injury'.[1466] This case law could be likewise transposed to the CVDs context. In sum, by relying on the vague standards of 'positive evidence' and 'objective examination', panels and the Appellate Body have put some constraints on investigating authorities' discretion to choose the period of investigation. Such contract completion might be criticized as a form of 'judicial activism'[1467] but this is, in my opinion, justified because it acknowledges that the choice of the investigation period might indeed be done in a way undermining the quality and objectiveness of the data. In the cases at hand, there seemed to be sufficient elements present

[1459] See also Panel Report, *Mexico – Olive Oil*, para 7.266.
[1460] Panel Report, *Mexico – Olive Oil*, para 7.267.
[1461] The Panel found inspiration in the Appellate Body Report, *Mexico – Anti-Dumping Measures on Rice,* para 183; Panel Report, *Mexico – Anti-Dumping Measures on Rice*, paras 7.80-7.82.
[1462] For example, in *Mexico – Olive Oil*, Mexico had used data from nine month periods in successive years and could not give a reasonable explanation why it did not use full year data (see also below n 1468). Panel Report, *Mexico – Olive Oil*, paras 7.288-7.289.
[1463] Appellate Body Report, *Mexico – Anti-Dumping Measures on Rice,* para 183; Panel Report, *Mexico – Olive Oil*, para 7.288.
[1464] There was a 15-month gap between the end of the period of investigation and the initiation of the investigation as well as a gap of almost three years between the end of the period of investigation and the imposition of final anti-dumping duties. This temporal aspect was not on itself a violation but several other elements showed that Mexico offered no valid justification why more recent data had not been used. Appellate Body Report, *Mexico – Anti-Dumping Measures on Rice*, para 167.
[1465] Appellate Body Report, *Mexico – Anti-Dumping Measures on Rice,* para 165.
[1466] Appellate Body Report, *Mexico – Anti-Dumping Measures on Rice*, para 166.
[1467] For a discussion on this debate, see WorldTradeLaw.net Dispute Settlement Commentary on Panel Report, *Mexico – Anti-Dumping Measures on Rice*, at 18-19.

which diluted not only the quality of the evidence but even questioned the 'good faith'-intentions on the part of the investigating authorities to make an unbiased examination.[1468]

The Appellate Body in *Mexico – Anti-Dumping Measures on Rice* also observed that no type of methodology is prescribed for an investigating authority conducting an injury analysis. As a result, such a methodology could rest on *assumptions* but the 'positive evidence'-standard nonetheless mandates that such 'assumptions should be derived as reasonable inferences from a credible basis of facts, and should be sufficiently explained so that their objectivity and credibility can be verified'.[1469] Hence, the Appellate Body decided in the anti-dumping context that 'an investigating authority that uses a methodology premised on unsubstantiated assumptions does not conduct an examination based on positive evidence'.[1470] This occurs, for instance, if the investigating authority fails to explain why it would be appropriate to use assumptions in its analysis. Again, this case law is relevant in the context of CVDs investigations. In the following sections, the 'injury'-test to be conducted in a CVDs investigation is explored.

5.2.2.2.2. Volume and/or price effect

An injury determination should involve an objective examination of the volume of subsidized imports and the effect of such subsidized imports on prices. Regarding the *volume effect*, the investigating authority has to consider whether there has been a significant increase in 'subsidized imports', either in absolute terms or relative to production or consumption in the importing Member. In this analysis, only those imports qualify for which a *de minimis* margin of subsidization has been found.[1471] Regarding the *price effect* of the subsidized imports, it has to be determined whether there has been significant price undercutting or significant price depression/suppression.[1472] Because 'no one or several of these factors can necessarily give decisive guidance' (Article 15.2 of the SCM Agreement), the Panel in *EC – Countervailing Measures on DRAM Chips* found that, even in absence of a significant increase in subsidized imports (volume effect), CVDs could be imposed as long as the price

[1468] In *Mexico – Olive Oil*, Mexico had precisely excluded those months when the seasonal, agricultural domestic industry was actually producing the product under investigation. In *Mexico – Anti-Dumping Measures on Rice*, the investigating authority had accepted the period of investigation proposed by the petitioner, knowing that the petitioner proposed that period because it allegedly represented the period of highest import penetration. Panel Report, *Mexico – Olive Oil*, paras 7.288-7.289; Appellate Body Report, *Mexico – Anti-Dumping Measures on Rice*, para 181.
[1469] Appellate Body Report, *Mexico – Anti-Dumping Measures on Rice,* para 204.
[1470] Appellate Body Report, *Mexico – Anti-Dumping Measures on Rice,* para 204.
[1471] Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.298, footnote 227.
[1472] The determination can be based on one or more of these factors (Article 15.2 of the SCM Agreement).

effect is present.[1473] In contrast to safeguard investigations, there is 'no generalized requirement to establish a temporal correlation between increased imports and injury in the context of a countervail investigation'.[1474] The absence of such a temporal correlation 'certainly raises a flag, but it is not an absolute barrier to a finding of injury'.[1475]

A novelty introduced in the SCM Agreement upon US demand is the allowance to cumulate the effects of subsidized imports from more than one Member, all subject to CVDs investigations. This gives the right to add up subsidy effects which, on their own, might be insufficient to generate the required level of trade distortion (i.e., volume and/or price effect) and injury. Such a cumulative assessment could be conducted if two conditions are fulfilled.[1476] First, the subsidy amount related to imports from each country is above the 1 per cent *de minimis* level and the volume is not negligible.[1477] Second, such an assessment should be appropriate in light of the conditions of competition between the imported products and the conditions of competition between the imported products and the like domestic product.[1478]

5.2.2.2.3. Impact of volume and/or price effect on the state of the domestic industry

What can be the impact upon domestic industry of these volume and/or price effects? To this end, the investigating authority has to evaluate all relevant economic factors and indices having a bearing on the state of the industry. Article 15.4 of the SCM Agreement includes an elaborated but non-exhaustive list of relevant factors, none of which could necessarily give decisive guidance:

> (…) actual and potential decline in output, sales, market share, profits, productivity, return on investments, or utilization of capacity; factors affecting domestic prices; actual and potential negative effects on cash flow, inventories, employment, wages, growth, ability to raise capital or investments and, in the case of agriculture, whether there has been an increased burden on government support programmes.

The Panel in *EC – DRAMS Countervailing Measures* held that all these factors should definitely be evaluated to assess the state of the domestic industry.[1479] Even if some

[1473] Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.399, footnote 277.
[1474] Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.399, footnote 277; Panel Report, *US - Countervailing Duty Investigation on DRAMS*, para 7.320, footnote 283.
[1475] Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.399, footnote 277.
[1476] Article 15.3 of the SCM Agreement. There was no agreement on whether the Subsidies Code allowed such cumulative assessment. Balassa considered such an assessment as justified from an economic viewpoint because the combined effect of foreign subsidies is what matters for the domestic industry. See B. Balassa, 'Subsidies and Countervailing Measures: Economic Considerations', in B. Balassa (ed), *Subsidies and Countervailing Measures – Critical Issues for the Uruguay Round* (Washington: The World Bank, 1989), 28-45, at 38.
[1477] In case of CVDs action against developing countries, higher *de minimis* subsidy and volume thresholds apply (Article 27.10 of the SCM Agreement; see below Part I, Chapter 6, Section 6.1.3).
[1478] Article 15.3 of the SCM Agreement.
[1479] Article 15.4 of the SCM Agreement. See Panel Report, *EC – DRAMS Countervailing Measures*, para 7.356.

individual factors show a positive development for the domestic industry, an overall assessment could lead to the conclusion of material injury.[1480]

5.2.2.2.4. Definition of domestic industry

The material injury should be caused upon the 'domestic industry'. This domestic industry is defined as 'the domestic producers *as a whole of the like products* or to those of them whose collective output of the products constitutes *a major proportion* of the total domestic production of those products'.[1481] Yet, some domestic producers could be excluded from this definition, namely those that are related to exporters or importers, or are themselves importers of the allegedly subsidized product or a like product from other countries.[1482] As these producers likely benefit from the subsidized imports as a result of such relationship, they clearly do not share the same interest as the rest of the domestic industry and are in all probability not injured.

In principle, it should thus be shown that injury is caused upon 'the domestic producers as a whole of the like products'. As elaborated upon above, the concept of 'like product' covers products that are 'identical, i.e. alike in all respects' or, at least, as having 'characteristics closely resembling'. Even the latter concept is, according to the Panel in *Indonesia – Autos*, 'on its face (…) quite narrow' and 'includes but is not limited to physical characteristics'.[1483] Relevantly, the Panel in *Mexico – Olive Oil* decided that 'domestic producers' does not exclude those producers that at the time of application and/or during the period of the injury investigation did not actually produce the like product. The Panel convincingly explained that deciding otherwise would be absurd and contrary to the intention of the drafters as it 'could lead to the result that an industry may be so badly injured by subsidized imports as to be forced to cease production for some period, but would be disqualified from obtaining the very remedy aimed at addressing such injury'.[1484] Despite the lack of production during the period of investigation, the enterprise in question (Fortuna) was still considered a 'producer' in the meaning of Article 16.1 of the SCM Agreement because 'the essential nature of its business' was still the production, distribution, and sale of the like product (i.e., olive oil).[1485]

Two further important observations have to be made on the delineation of the domestic industry with regard to the injury determination. First, as Mavroidis et al accurately emphasize, CVDs action could only be undertaken when injury is suffered by the domestic

[1480] Panel Report, *EC – DRAMS Countervailing Measures*, para 7.372.
[1481] Article 16.1 of the SCM Agreement (emphasis added).
[1482] Article 16.1 of the SCM Agreement. For the definition of 'related', see footnote 48 of the SCM Agreement.
[1483] See footnote 46 of the SCM Agreement; Panel Report, *Indonesia – Autos*, para 14.173.
[1484] Panel Report, *Mexico – Olive Oil*, para 7.203.
[1485] Panel Report, *Mexico – Olive Oil*, para 7.213

producers of the like product that is imported.[1486] For instance, if *wine* is the subsidized imported product, CVDs could only be imposed in case domestic *wine* producers are harmed. If these domestic wine producers are able to withstand competition form imported subsidized wine by negotiating a lower price from domestic input (e.g., grape) producers, no CVDs action could be undertaken to offset this indirect effect on the input producers because grapes are not like products to wine. This conclusion equally holds if the subsidy is originally given to the upstream industry (i.e., grape producers) in the subsidizing country, which is 'passed through' to the downstream industry exporting the processed product (i.e., wine producers).[1487] In sum, CVDs could only be imposed if it is shown that the traded product is subsidized (which might require a pass-through analysis)[1488] and if this subsidized traded product causes harm to 'like products' in the importing country.

Second, it is required that the domestic producers *as a whole* producing the like product, or a major proportion of them, are injured.[1489] Hence, CVDs-investigating authorities could not simply single out those domestic producers that have been harmed, and exclude others also producing the like product that apparently have not been injured. Material injury should be established on the level of the entire domestic industry, with the caveat that those domestic producers collectively having a 'major proportion' of total domestic production might suffice.[1490] Yet, this principle should be further qualified in a twofold way. First, as noted, domestic producers related to producers of the subsidized product could be excluded from the 'domestic industry'. Second, the SCM Agreement allows, 'in exceptional circumstances', to divide the territory of a Member into two or more competitive markets and to treat producers within each market as a separate industry. Such segmentation is only allowed if industries are sufficiently separate, which is the case if:

> (a) the producers within such market sell all or almost all of their production of the product in question in that market, and
> (b) the demand in that market is not to any substantial degree supplied by producers of the product in question located elsewhere in the territory

In such circumstances, injury may be found to exist in a market segment even where a major proportion of the total domestic industry is not injured. Yet, two further conditions have to be

[1486] See Mavroidis, Messerlin, and Wauters, above n 729, at 371-372.
[1487] See Mavroidis, Messerlin, and Wauters, above n 729, at 372.
[1488] This results from the obligation that CVDs cannot be imposed above the subsidy level. See above Part II, Chapter 3, Section 3.2.2.1.
[1489] This was established by the Appellate Body in the anti-dumping context but seems likewise applicable in the CVDs context given parallel provisions in the SCM Agreement (Article 16.1 of the SCM Agreement; see also Articles 15.1, 15.2, 15.4, 15.5, 15.6, 15.7 of the SCM Agreement). Obviously, this does not exclude that 'a sectoral analysis may be highly pertinent, from an economic perspective, in assessing the state of an industry as a whole'. Appellate Body Report, *US – Hot-Rolled Steel*, paras 189-190, 195. See also Panel Report, *Mexico – Corn Syrup*, para 7.147.
[1490] Of course, it could be the case that only one single enterprise constitutes the entire domestic industry. See, for example, Panel Report, *Mexico – Olive Oil*, para 7.248.

fulfilled: (i) there is a concentration of subsidized imports in such an isolated market and (ii) the subsidized imports are causing injury to the producers of *all or almost all* of the production within such market.[1491] In principle, CVDs should then only be levied on the imported products consigned for final consumption to that area.[1492]

5.2.2.2.5. Threat of injury

The concept of 'injury' encompasses *threat* of material injury. This means that CVDs can be imposed to offset subsidies that merely cause a threat to injury to a domestic industry.[1493] The determination of such a threat of material injury should be based on facts and not merely on allegation, conjecture, or remote possibility and the application of CVDs should be considered and decided with 'special care'.[1494] Moreover, the change in circumstances that would trigger the subsidy to cause injury must be 'clearly foreseen and imminent'. To be sure, this does not require, according to the Panel in *US – Softwood Lumber VI*, to identify a single or 'specific event that would change such that a situation of no injury will become a situation of injury in the future'.[1495] The change in circumstances could likewise consist of 'a series of events, or developments in the situation of the industry, and/or concerning (…) the subsidized imports' that would lead to the prediction that injury would incur imminently.[1496] In making a determination of a threat of material injury, the SCM Agreement once more specifies a non-exhaustive list of factors that should certainly be considered:

> (i) nature of *the subsidy* or subsidies in question and the trade effects likely to arise therefrom;
> (ii) a significant rate of increase of *subsidized imports* into the domestic market indicating the likelihood of substantially increased importation;
> (iii) sufficient freely disposable, or an imminent, substantial increase in, *capacity* of the exporter indicating the likelihood of substantially increased subsidized exports to the importing Member's market, taking into account the availability of other export markets to absorb any additional exports;
> (iv) whether imports are entering at *prices* that will have a significant depressing or suppressing effect on domestic prices, and would likely increase demand for further imports; and
> (v) inventories of *the product* being investigated.[1497]

Again, none of these factors is decisive on its own but 'the totality of the factors considered must lead to the conclusion that further subsidized exports are imminent and that, unless protective action is undertaken, material injury would occur'.[1498]

[1491] Article 16.2 of the SCM Agreement.
[1492] An exception is made in case constitutional laws of the CVDs-imposing country do not allow CVDs on such a basis. See Article 16.3 of the SCM Agreement.
[1493] Articles 15.7 and 15.8 of the SCM Agreement. See also Appellate Body Report, *US – Softwood Lumber VI (Article 21.5 – Canada)*, paras 96-99.
[1494] Article 15.8 of the SCM Agreement.
[1495] Panel Report, *US – Softwood Lumber VI*, para 7.60
[1496] Panel Report, *US – Softwood Lumber VI*, paras 7.53-7.60.
[1497] Article 15.7 of the SCM Agreement (emphasis added).

5.2.2.3. Causation

As a final step, it must be demonstrated that 'the subsidized imports are, through the effects of the subsidies, causing injury' (Article 15.5 of the SCM Agreement).[1499] This requirement is split in two complementary parts. First of all, the investigating authority should demonstrate a causal link based on an examination of all relevant evidence (causal relationship requirement). In *US – Softwood Lumber VI (Article 21.5 – Canada)*, the Appellate Body held that the investigating authority must demonstrate that further subsidized imports would cause injury.[1500] Second, the investigating authority has to explicitly filter out 'any known factors' causing injury at the same time and the injury caused by these other factors should not be attributed to the subsidized import (non-attribution requirement).[1501] Factors which *may* be relevant in this respect include:

> (…) the volumes and prices of non-subsidized imports of the product in question, contraction in demand or changes in the patterns of consumption, trade restrictive practices of and competition between the foreign and domestic producers, developments in technology and the export performance and productivity of the domestic industry.[1502]

The Panel in *Mexico – Olive Oil* distinguished two basic components in this non-attribution requirement.[1503] First, an investigating authority is obliged to list those factors known to it either as a result of its own investigation or because they were raised by the interested parties. Second, an investigating authority is required 'to analyze each of these factors separately and to explain the nature and extent of the injurious effects of these other factors, separating and distinguishing them from the injurious effects of the subsidized imports'.[1504] If the facts of the case so warrant, an investigating authority is to consider in addition the collective impact of the 'other known factors'.

Turning back the causal relationship requirement, an important unsettled question in the CVDs context is whether investigating authorities are required to demonstrate that, once these other known factors are separated, subsidized imports are sufficient on their own to cause a level of *material* injury.[1505] In the safeguards context, the Appellate Body has made the contestable interpretation that there is no obligation to show that 'increased imports *on their own* must be capable of causing serious injury' but only that increased imports bear a

[1498] Article 15.7 of the SCM Agreement.
[1499] Articles 15.5 and 19.1 of the SCM Agreement.
[1500] Appellate Body Report, *US – Softwood Lumber VI (Article 21.5 – Canada)*, para 132.
[1501] Article 15.5 of the SCM Agreement.
[1502] Article 15.5 of the SCM Agreement.
[1503] Panel Report, *Mexico – Olive Oil*, para 7.305.
[1504] Panel Report, *Mexico – Olive Oil*, para 7.305.
[1505] See also Clarke and Horlick, above n 587, at 745.

'genuine and substantial relationship of cause and effect' with serious injury.[1506] However, it has not yet been clarified whether this more flexible but vague causation standard is also applicable in the context of CVDs procedures. This would imply that subsidized imports would only have to bear a 'genuine and substantial relationship of cause and effect' to material injury, instead of being sufficient on their own to cause *material* injury.[1507]

In CVDs and anti-dumping trade remedy cases, investigating authorities often rely on regression analysis to test whether subsidized (or dumped) imports cause (material) injury.[1508] In general, such models seek to statistically establish the relationship between a *dependent* variable, whereby a proxy for injury to the domestic industry is used (e.g., the price of the domestically produced good, employment, output), and a set of *independent* variables, which include next to a proxy for the effect of the subsidized imports (e.g., price, volume or profit margin) also other control variables that may affect the domestic industry (e.g., prices of substitute, input, and downstream goods; general economic conditions).[1509] By controlling for these other variables, their effect on the domestic industry is not attributed to subsidized imports, as required by the non-attribution requirement.[1510] The regression analysis thus allows establishing whether, controlling for these other variables, there is a positive, negative or no relationship (i.e., correlation) between the conditions in the domestic industry and the price, volume or profit margin of subsidized (or dumped) imports as well as to quantify any

[1506] Appellate Body Report, *US – Wheat Gluten*, paras 67, 69, 70; Appellate Body Report, *US – Lamb*, paras 168-170.

[1507] Article 15.5 of the SCM Agreement bears some similarity with Article 4.2(b) of the Safeguards Agreement, which might suggest that the Appellate Body would reach the same interpretation under the SCM Agreement. The former, for example, refers to 'causal relationship', whereas the SCM Agreement refers to 'causal link'. On the other hand, the opening sentence of Article 15.5 of the SCM Agreement explicitly stipulates that '(i)t *must* be demonstrated that the subsidized imports are, (…), *causing injury within the meaning of this Agreement*' (emphasis added). This clearly suggests that subsidized imports should be sufficient to cause *material* injury. Moreover, the object and purpose of CVDs provisions is, according to the Panel in *Mexico – Olive Oil*, 'to provide for application of trade remedies where *subsidized imports cause material injury*' (Panel Report, *Mexico – Olive Oil*, para 7.202, emphasis added). Hence, the object and purpose of CVDs action is not to allow such action in case they are only responsible for a 'sub-material' part of the demonstrated 'material' injury to the domestic industry.

[1508] The case law has also underscored the relevance of a quantitative analysis. The Panel in *EC – Countervailing Measures on DRAM Chips*, for instance, concluded that, instead of making qualitative assertions, an investigating authority 'must make a better effort to quantify the impact of other known factors, relative to subsidized imports, preferably using elementary economic constructs or models' (para 7.405).

[1509] J. J. Fetzer, 'Inference for Econometric Modeling in Antidumping, Countervailing Duty and Safeguard Investigations', 8:4 *Journal of World Trade* (2008), 545-557, at 547-548.

[1510] Hence, regression models allow detecting (and thus rejecting) 'spurious correlations', whereby the effect on domestic prices is not caused by subsidized imports but by other factors. At the same time, they also allow revealing (and thus accepting) 'spurious correlations', whereby the real effect of the subsidized imports on domestic prices was hidden by other factors. See Steinberg and Josling, above n 1153, at 390-392.

such relationship.[1511] Strictly speaking, only (the degree of) correlation could be detected and not causation. One specific regression model often used in trade remedy cases to partly counter this problem is the 'Granger-causality' model. A variable x (e.g., volumes or prices of subsidized imports) is considered to 'granger-cause' another variable y (e.g., domestic prices), if past values of x (e.g., volumes or prices of imports) provide information for predicting current and future values of y (e.g., domestic prices).[1512] To be sure, 'granger-causality' does not detect causality in the meaning of 'necessary condition' but rather corresponds to causality as 'constant conjunction'.[1513] Moreover, the data requirements to conduct econometric estimation, and certainly to run the 'Granger-causality' model, are demanding.[1514]

Importantly, these econometric models test whether *subsidized imports* – and not subsidies *as such* – cause injury to the domestic industry. Indeed, prices/volumes of subsidized imports and not subsidies are included as independent variables. As they are mostly only observed on an annual basis, 'subsidies' can simply not be included as independent variable because the data requirements would not be fulfilled.[1515] Hence, the estimated outcomes only detect whether and to what extent the volume and/or price of *subsidized imports*, holding other factors constant, are correlated with – or Granger-cause – injury to the domestic industry proxies. In contrast, econometric models do not reveal whether such volume and/or price effects are the effect of *subsidization*. 'Subsidized imports' are included in the model on the basis of a preliminary determination that foreign importing producers are subsidized. Such 'bifurcation' between the injury test and the subsidy test could easily lead to false positive or higher than justified CVDs determinations (so-called Type 2 errors).[1516] Even if foreign producers are subsidized, the surge in their imports into the investigating country could very well be (partly) explained by other factors than subsidization (e.g. increase in competitiveness) but this is not detected under the bifurcated test as employed in practice. Consider, for the example, the US CVDs investigations, whereby such bifurcation is

[1511] WTO Secretariat, *World Trade Report 2005 – Exploring the links between trade, standards and the WTO* (Geneva: WTO Publications, 2005), 333 pp., at 200-201.

[1512] The addition to a regression of past values of x improves the prediction (e.g., statistically significant reduction in the mean square error) of future values of y. See World Trade Report 2005, above n 1511, at 201.

[1513] According to the World Trade Report 2005, causality as 'constant conjunction' is Hume's characterization. World Trade Report 2005, above n 1511, at 201.

[1514] Relying on time series data, the models require that sufficient observations can be made at regular intervals during such reference period. In order to rely on granger-causality in trade remedy cases, data must be available on a monthly or quarterly basis. World Trade Report 2005, above n 1511, at 201; Sapir and Trachtman, above n 1195, at 201.

[1515] Sapir and Trachtman, above n 1195, at 201.

[1516] R. Diamond, 'Privatization and the Definition of Subsidy: A Critical Study of Appellate Body Texturalism', 11:3 *Journal of International Economic Law* (2008), 1-30, at 26.

institutionalized.[1517] USDOC determines whether subsidizion as defined in the SCM Agreement (or Agreement on Agriculture) is taking place, and if so, determines the subsidy amount. Yet, it hereby does not consider whether subsidization has had an effect on output levels.[1518] Subsequently, the United States International Trade Commission (USITC) determines whether such 'subsidized imports' (threaten to) materially injure the US domestic industry.[1519] Correlation (or Granger causality) between subsidized imports and injury proxies is tested on the basis of econometric modeling and the effective occurrence of volume expanding or price suppressing effects could also be easily observed on the basis of import data. The 'missing link' in the investigation is that any volume or price effect of subsidized imports is simply assumed to be the effect of subsidization. This could lead to a false positive finding, for example, in case a subsidized foreign producer would have also expanded its output levels in the absence of subsidization (e.g., build a new plant because of a rise in competiveness). Obviously, this might generate higher import levels into the investigating country that are in fact not the effect of subsidization.

Although the legal text unequivocally prescribes that it must be demonstrated that the 'subsidized imports are, *through the effects of subsidies*, causing injury',[1520] the case law has systematically read out this obligation from Article 15.5 of the SCM Agreement. It suffices, by reliance for instance on regression analysis, to demonstrate that *subsidized imports* cause injury. Thus, an additional demonstration that the injury is caused by the effects of the *subsidy* is not requisite. In *Japan – DRAMs (Korea)*, Korea had advocated such an additional examination precisely because 'the increase in the volume of subsidized imports or the price at which they are sold on the importing Member's market may not have been caused by the subsidies received by the exporting company'.[1521] For instance, Korea correctly suggested that increased volumes of imports could be due to other factors than the subsidy such as better quality, design, innovation, or customer preference.[1522] However, the Appellate Body failed

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[1517] Diamond, above n 1516, at 26; A. O. Sykes, 'The Economics of "Injury" in Antidumping and Countervailing Duty Cases', in J. S. Bhandari and A. O. Sykes (eds), *Economic Dimensions in International Law – Comparative and Empirical Perspectives* (Cambridge: Cambridge University Press, 1997), 83-125.
[1518] See Diamond, above n 1516, at 26.
[1519] If both USDOC and USITC reach affirmative final determinations on their individual questions, USDOC will issue a CVDs order to offset the effect of the subsidy.
[1520] Emphasis added.
[1521] Appellate Body Report, *Japan – DRAMs (Korea)*, para 265.
[1522] Korea acknowledged that if the subsidy was in fact the impetus behind the superior quality, the injury to the domestic industry could be attributed to the subsidy. See Appellate Body Report, *Japan – DRAMs (Korea)*, para 266, footnote 472. Hence, Korea did not aruge, like Crowley and Palmeter present it, that 'if a subsidy improved product quality (…) there would be no basis for findings that the imports, that happened to be subsidized, had caused injury "through the effects of subsidies" '. This does not correspond to Korea's argumentation in paragraph 82, to which these authors refer. M. A. Crowley and D. Palmeter, 'Japan – Countervailing Duties on Dynamic Random Access Memories from

to read an obligation for such an additional examination[1523] in Article 15.5 of the SCM Agreement.[1524,1525] In the Appellate Body's view, the non-attribution requirement already addresses 'adequately the concern that the injurious effects of any known factors *other than subsidized imports* are not attributed to the subsidized imports' because this requirement 'ensures that injuries that may have been caused by other known factors are not attributed to the subsidized imports'.[1526] However, in my opinion, this does not give in to the concern raised by Korea. After all, the non-attribution requirement does not seem to detach those factors attached to the 'subsidized imports' that do not result from subsidization (e.g., quality, innovation). Note in conclusion that Korea's reasoning that the causality requirement in CVDs procedures should be interpreted similarly as under Article 6.3 of the SCM Agreement (serious prejudice claims) was explicitly refuted by the Appellate Body. Here, the Appellate Body referred to 'the difference between the text, context, rationale, and object of the provisions in Part III and Part V of the SCM Agreement'.[1527] Apparently, whereas 'serious prejudice' should be the effect of the subsidy (Article 6.3), material injury to the domestic industry should only be the effect of the 'subsidized imports'.[1528]

In conclusion, the causation requirement as interpreted in the case law does *not* seem to filter out only those *subsidies* that are effectively causing *material* injury. First, *if* the causation standard of the safeguards context would be transposed to the CVDs context, the required level of 'material' injury might be partly caused by other factors. Second, the demonstrated *causal* link between 'subsidized imports' and injury does not ensure that such injury has in fact been caused by subsidization.

5.2.3. Imposition of countervailing duties

Prior to the discussion on the imposition of (provisional or final) CVDs measures, an alternative should be pointed out. This alternative refers to voluntary undertakings under

Korea (DS 336 and Corr.1, adopted 17 December 2007)', 8:1 *World Trade Review* (2009), 259-272, at 270.

[1523] Such an additional examination suggested by Korea would, according to the Appellate Body, require an inquiry into two matters: (i) the use to which the subsidies were put by the exporting company; (ii) whether, absent the subsidies, the product would have been exported in the same volumes or at the same prices. Appellate Body Report, *Japan – DRAMs (Korea)*, para 266.

[1524] The Appellate Body referred to footnote 47 of the SCM Agreement which is footnoted to the term 'effect' in Article 15.5 of the SCM Agreement and reads: 'As set forth in paragraphs 2 and 4' (volume/price effect and the impact on the domestic industry). Appellate Body Report, *Japan – DRAMs (Korea)*, paras 263-266.

[1525] For the same reason, the Appellate Body's finding was criticized by Crowley and Palmeter. See Crowley and Palmeter, above n 1522, at 263-264, 269-270.

[1526] Appellate Body Report, *Japan – DRAMs (Korea)*, para 267 (emphasis in the original).

[1527] Appellate Body Report, *Japan – DRAMs (Korea)*, para 272.

[1528] The latter could also be relied upon in an actionable subsidy claim before the WTO dispute settlement system by virtue of Article 5(a) of the SCM Agreement.

which (a) the *exporting Member* agrees to eliminate or limit the subsidy[1529] or takes other measures concerning its effect or (b) the *exporter* agrees to revise its price so that the investigating authorities are satisfied that the injurious effect of the subsidy is eliminated.[1530] Indeed, such undertakings provide an equal protection for producers in the importing country. Of course, the national welfare effects are different given that CVDs are collected by the importing Member, whereas these economic benefits in case of undertakings flow to the exporting Member (a) or the exporters (b).[1531] The importing investigating Member does not have to accept the undertaking if its acceptance is considered impractical (e.g., if the number of exporters is too great) or for other reasons such as general policy.[1532] Moreover, it can accept an undertaking only after a preliminary affirmative determination of a subsidy causing injury. The investigation will nevertheless continue if either the exporting Member or the importing Member so desires. If this final determination is negative, the undertaking shall lapse except when this determination results from the undertaking itself. If it is positive, the undertaking shall continue.[1533]

Before the termination of an investigation, a WTO Member is allowed to impose provisional CVDs (in the form of cash deposits or bonds[1534]) if three conditions are fulfilled.[1535] First, an investigation has been initiated at least 60 days before and interested Members and interested parties have been given adequate opportunity to submit information and make comments (procedural requirement). Second, a preliminary affirmative determination has been made on the three substantive elements (subsidy, injury, and causal relation). Third, the authorities judge provisional CVDs necessary to prevent injury being caused during the investigation. If a final determination is made about a subsidy causing injury, a WTO Member is allowed to impose definitive CVDs unless the subsidy is withdrawn.[1536,1537]

The level of (provisional or definitive) CVDs imposed by the importing Member may not exceed the amount of the subsidy (Article 19.4 of the SCM Agreement).[1538] It is merely 'desirable' that the duty should be less than the amount of the subsidy if such lesser duty

[1529] If a subsidy is withdrawn, a Member cannot impose CVDs (see Article 19.1 of the SCM Agreement).
[1530] The exporting Member should agree with undertakings from exporters (Article 18.2 of the SCM Agreement).
[1531] In all situations, the negative effect on consumers in the importing country is the same because of the higher price.
[1532] Article 18.3 of the SCM Agreement.
[1533] Article 18.4 of the SCM Agreement. See Article 21.5 of the SCM Agreement for the duration of accepted undertakings.
[1534] Article 17.2 of the SCM Agreement.
[1535] Article 17.1 of the SCM Agreement.
[1536] Article 19.1 of the SCM Agreement.
[1537] The term 'countervailing duty' is defined in footnote 36 of the SCM Agreement and Article VI:3 of the GATT 1994.
[1538] For provisional CVDs, see Article 17.2 of the SCM Agreement.

would be adequate to remove the injury ('lesser duty'-rule).[1539] So, the level of CVDs can exceed the injury caused to the domestic industry, depending on the autonomous decision of the CVDs-investigating authority.

The obligation to not impose CVDs above the subsidy level (Article 19.4 of the SCM Agreement) implies, in the view of the Panel as well as the Appellate Body in *Japan – DRAMs (Korea)*, that CVDs may only be imposed if there is *present subsidization* at the time of duty imposition.[1540] This requirement to establish present subsidization does not mean that investigating authorities are prevented from establishing the existence of subsidization (and injury and causing) by reference to data taken from a past period of investigation.[1541] Nonetheless, the Panel held that, in the case of non-recurring subsidies, 'if the review of the period of investigation indicates that the subsidy will no longer exist at the time of *imposition*, the existence of subsidization during the *period of investigation* will not suffice to demonstrate *current* subsidization at the time of imposition'.[1542] In other words, investigating authorities will have to establish that the CVDs are imposed on products that are still benefiting from the non-recurring subsidy. One such method, adopted by Japan in this case, is to allocate (spread out) the amount of the benefit conferred by the non-recurring subsidy over the useful life of the product. The useful life of the subsidized production facilities in this case was determined by Japan as five years (2001–2005). The Panel did not question this 'useful life' approach in general or the determination by Japan but concluded that this five-year allocation period is a finding that the benefit will expire after a period of five years and that Japan thus failed to demonstrate subsidization at the time of the imposition of CVDs (year 2006).[1543] In the Negotiating Group on Rules, proposals have been formulated to introduce rules on how subsidy benefits should be allocated.[1544]

Finally, recall that Members are allowed to perform an investigation on an aggregate basis.[1545] As clarified by the Appellate Body in *US – Softwood Lumber IV*, CVDs have to be imposed on all sources found to be subsidized, although no prior investigation of all individual exporters

[1539] Articles 17.5 and 19.2 of the SCM Agreement.

[1540] Panel Report, *Japan – DRAMs (Korea)*, para 7.355; Appellate Body Report, *Japan – DRAMs (Korea)*, para 210.

[1541] Indeed, the Panel recognized that investigating authorities have no choice because of the procedural requirements to establish the existence of subsidization (and injury) on the basis of past investigation periods. Panel Report, *Japan – DRAMS Countervailing Duties,* para 7.356; Appellate Body Report, *Japan – DRAMs (Korea)*, para 209.

[1542] Emphasis added. See Panel Report, *Japan – DRAMs (Korea)*, para 7.357.

[1543] Panel Report, *Japan – DRAMS Countervailing Duties*, para 7.360. See also above Part II, Chapter 3, Section 3.2.2.1.

[1544] See, for example, *Communication from the United States*, *Allocation and Expensing of Subsidy Benefits* (TN/RL/GEN/130, April 24, 2006); *Paper from Brazil, Allocation of Subsidy Benefits* (TN/RL/W/192, November 23, 2005).

[1545] Article 19.3 of the SCM Agreement.

is required.[1546] An exporter who faces CVDs but was not investigated (for reasons other than a refusal to cooperate) is entitled to an expedited review so that an individual CVDs rate (or no rate at all) is established.[1547] Such a CVDs investigation on an aggregate basis is thus, as Horn and Mavroidis have correctly argued, by definition imprecise as it could lead to CVDs on individual products which do not amount to the actual level of subsidization. According to the same authors, this has the effect to shift the burden of proof from the CVDs-investigating authorities towards individual exporters, who have to show that they have not (or to a lesser extent) benefited from subsidization.[1548] Yet, the case law does not seem to place the burden on the exporter requesting an expedited review to show that he has not been subsidized.[1549]

5.2.4. Duration of countervailing duties

A first question with regard to the duration of CVDs is their starting point. In general, provisional and definitive CVDs can only be imposed upon products that enter the country following the imposition of such measures. Only in 'critical circumstances'[1550] may definitive CVDs be assessed retroactively. This is limited to goods imported for consumption not more than 90 days prior to the application of provisional CVDs.[1551] In contrast, provisional CVDs can never be applied retroactively.[1552]

What if there is a discrepancy between the level of provisional and definitive CVDs?[1553] If the definitive CVD is higher, the difference shall not be collected, whereas if the definitive duty is lower than the cash deposit or bond, the difference must be reimbursed or the bond released in an expeditious manner.[1554] On the other hand, if a final determination is *negative*, provisional measures have to be undone: cash deposits should be refunded and bonds released in an expeditious manner (Article 20.5 of the SCM Agreement). The same applies in case a

[1546] Appellate Body Report, *US – Softwood Lumber IV*, para 152. Such an aggregate investigation might result in a lower maximum CVDs level because the subsidy amount will have to be spread out over a larger amount of products. See Appellate Body Report, *US – Softwood Lumber IV*, para 164, footnote 196.
[1547] Article 19.3 of the SCM Agreement.
[1548] Horn and Mavroidis, above n 819, at 715.
[1549] Appellate Body Report, *US – Softwood Lumber IV*, para 164.
[1550] Regarding the specific conditions, see Article 20.6 of the SCM Agreement.
[1551] Article 20.6 of the SCM Agreement.
[1552] Panel Report, *US – Softwood Lumber III*, paras 7.93-7.94.
[1553] Articles 20.2-20.4 of the SCM Agreement. Strictly speaking, definitive CVDs replace provisional CVDs and are thus applied retroactively in case of a positive final determination. This is therefore considered as a second exception on the general rule of the non-retroactive application of CVDs (see Article 20.2 of the SCM Agreement; Panel Report, *US – Softwood Lumber III*, paras 7.93-7.94). To be sure, if no provisional CVDs had been in place, definitive CVDs cannot be imposed retroactively under this exception.
[1554] Article 20.3 of the SCM Agreement.

final determination only finds a *threat of injury*, unless where the provisional measures exactly prevented that a determination of injury was made.[1555]

The application of provisional CVDs should be limited to as short a period as possible and may not exceed four months. Definitive CVDs may remain in force to the extent necessary to counteract the subsidization but may in principle not exceed five years.[1556] The SCM Agreement provides two review mechanisms that have an impact on the duration of definitive CVDs.

5.2.4.1. Administrative review

An administrative review should be conducted when initiated either by the investigating authority itself 'where warranted' or, after a reasonable period of time after the imposition, upon request of any interested party that submits positive information substantiating the need for a review.[1557] In particular, the following elements could be requested to review or could be reviewed *ex officio*: (1) whether the continued imposition of CVDs is necessary to offset the subsidy, and/or (2) whether the injury would be likely to continue or recur if the duty were removed. If the investigating authorities determine that the imposition of CVDs is no longer warranted, it must be terminated immediately. In contrast, if the outcome is a positive determination and the review covered injury as well as subsidization, the five-year period restarts.[1558]

5.2.4.2. Sunset review

To extend the imposition of CVDs beyond the (original or restarted) five years, a sunset review must be initiated before the end of this period by the investigating authority itself or on behalf of the domestic industry. CVDs could continue if the investigating authorities show that revocation of the duty is likely to lead to continuation or recurrence of the injury to the domestic industry. The sunset review should thus only be initiated before the end of the five-year period and should '*normally*' be concluded within 12 months. During this review, CVDs may remain in place.[1559] Hence, the SCM Agreement contains an important loophole to extend the imposition of CVDs beyond five years without, however, giving much guidance on the exact standard of review. Again, panels and the Appellate Body have been called upon to complete the contract in this respect. In particular, they had to decide on whether the

[1555] Article 20.2 *juncto* Article 20.4 of the SCM Agreement.
[1556] Articles 21.1 and 21.3 of the SCM Agreement.
[1557] Article 21.2 of the SCM Agreement.
[1558] Article 21.3 of the SCM Agreement.
[1559] Articles 21.3 and 21.4 of the SCM Agreement. Appellate Body Report, *US – Carbon Steel*, para 117, footnote 96.

procedural standards elaborated for the initial investigation *mutatis mutandis* apply for the sunset review. Yet, the EC unsuccessfully pleaded for such a parallel application in *US – Carbon Steel* to reinforce the procedural requirements upon the US sunset review procedure.
Article 21.3 of the SCM Agreement spells out two ways to initiate a sunset review: 'authorities (…) on their own initiative or upon a duly substantiated request made by or on behalf of the domestic industry'.[1560] The EC advocated in *US – Carbon Steel* that the evidentiary standards specified in Article 11.6 of the SCM Agreement for authorities to initiate an investigation on their own initiative also applies to the initiation of a sunset review on their own initiative. Based on a contextual analysis, the Appellate Body disagreed however. This means that the automatic self-initiation of sunset reviews by investigating authorities is not prohibited.[1561]
With regard to the substantive threshold for initiating a sunset review process, the SCM Agreement also does not clarify whether the *de minimis* standard of Article 11.9 of the SCM Agreement (1 per cent threshold) is applicable under the sunset review. Again, the Appellate Body in *US – Carbon Steel* did not transpose this standard to sunset reviews. Hence, CVDs could continue even if the level of subsidies has fallen below the *de minimis* level subsequent to the initial investigation.[1562] At the same time, in case the level of subsidization is very low at the time of the review, the Appellate Body stressed that 'there must be persuasive evidence that revocation of the duty would nevertheless lead to injury to the domestic industry'.[1563]

To continue the imposition of CVDs, such sunset review should lead to an 'an affirmative determination'[1564] that 'the expiry of the duty would be likely to lead to continuation or recurrence of subsidization and injury' (Article 21.3 of the SCM Agreement). The focus of the review determination is therefore on what 'would happen if an existing countervailing duty were to be removed'.[1565] This is, as the Panel in *US – Carbon Steel* emphasized, 'an inherently prospective analysis' but it must have an adequate basis in facts.[1566] In particular, a determination of likelihood must rest 'on the evaluation of the evidence that it has gathered during the original investigation, the intervening reviews and finally the sunset review'.[1567] Mavroidis has rightly questioned whether such a test could effectively be workable. After all, correctly assessing the likelihood that subsidization would recur in case of removal of duties

[1560] As emphasized by the Appellate Body, the phrase 'duly substantiated' only qualifies the initiation on behalf of the domestic industry. Appellate Body Report, *US – Carbon Steel*, para 103.
[1561] Appellate Body, *US – Carbon Steel*, paras 116 and 118.
[1562] The Appellate Body disagreed with the Panel on this element. Appellate Body, *US – Carbon Steel*, para 92.
[1563] Appellate Body, *US – Carbon Steel*, para 87.
[1564] Appellate Body, *US – Carbon Steel*, para 63.
[1565] Appellate Body, *US – Carbon Steel*, para 87.
[1566] Panel Report, *US – Carbon Steel*, paras 8.94-8.96.
[1567] Panel Report, *US – Carbon Steel*, paras 8.94-8.95.

would require insights in the future political leverage of the targeted industry in the (previously) subsidizing country. Because such a substantive test would be too demanding or even speculative, WTO-adjudicating bodies might rather adopt a pro-deference stance toward sunset reviews.[1568]

5.2.5. Standard of review

In case a CVDs determination is subsequently challenged before a panel, what is the panel's standard of review? In essence, the Appellate Body has warned that 'a panel may not conduct a *de novo* review of the evidence or substitute its judgment for that of the competent authorities'.[1569] Instead, 'it is the *explanation* given by the competent authority for its determination that alone enables panels to determine whether there has been compliance'.[1570] In short, panels should act 'as *reviewer* of agency action, rather than as *initial trier of fact*'.[1571] Panels therefore systematically reject to make a *de novo* review when CVDs determinations are challenged. They will not take the place of the investigating authority and make their own assessment on whether, given the available evidence, CVDs could legitimately be imposed.[1572] For instance, as explained above, the Panel in *US – Countervailing Duty Investigation on DRAMS* suggested that US DOC could have simply considered 100 per cent government-owned banks as 'public bodies'.[1573] Yet, because it was precluded from making a *de novo* review, the Panel only reviewed (and rejected) the US DOC's determination that private bodies were directed/entrusted by the Korean government.[1574] As a result, the Panel found that US DOC's determination was inconsistent with Article 1.1(a)(1) of the SCM Agreement, even though it suggested that the determination would have been WTO-consistent under another inference from the available factual findings.

Instead of making a *de novo* review, panels have to examine, by virtue of the obligation to make an 'objective assessment' (Article 11 of the DSU), whether the investigating authority provided 'a reasoned and adequate explanation' as to: (i) how the evidence on the record supported its factual findings; and (ii) how those factual findings supported its legal

[1568] Mavroidis, above n 1094, at 365.
[1569] Appellate Body Report, *US – Steel Safeguards*, para 299.
[1570] Appellate Body Report, *US – Steel Safeguards*, para 303 (emphasis in the original); Appellate Body Report, *Argentina – Footwear (EC)*, para 121; Appellate Body Report, *US – Softwood Lumber VI (Article 21.5 – Canada)*, para 93; Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, paras 183-184, 188.
[1571] Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 188 (emphasis in the original).
[1572] See, for example, Panel Report, *Japan – DRAMs (Korea)*, para 7.53.
[1573] See above Part II, Chapter 3, Section 3.2.2.
[1574] Panel Report, *US – Countervailing Duty Investigation on DRAMS*, paras 7.3, 7.8, 7.62, 7.190, footnote 202. See also Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.137.

assessment.[1575] Above, 'such explanation should be discernible from the published determination itself'.[1576] Where the investigating authority draws its conclusion from the *totality* of evidence, panels should assess whether individual pieces of evidence, which are on their own insufficient to make an inference, are adequate to reach that conclusion when viewed together.[1577] In deciding in *US – Countervailing Duty Investigation on DRAMS* on the basis of a single piece, the Panel had undertaken a *de novo* review of the evidence before the agency.[1578] Logically, the Appellate Body hereby specified that errors in an investigating authority's examination of individual pieces of evidence 'undoubtedly would affect an examination of the *totality* of the evidence, as these pieces would constitute the evidence the Panel would consider as a whole (…)'.[1579] At the same time, the Appellate Body in *Japan – DRAMs (Korea)* has emphasized that panels should not shield behind the prohibition to make a *de novo* review to effectively decide on whether such a flawed piece of evidence indeed leads to the rejection of the legal assessment. Japan's investigating authority had reached its legal assessment on the basis of the totality of evidence and did not consider the flawed factual finding (in this case commercial unreasonableness) as indispensable to this end. Therefore, the Panel should have examined whether the remaining factual findings (in this case government's intent and involvement in the restructuring process) could together be sufficient to infer the advanced legal determination (in this case entrustment or direction).[1580] Contrary to what the Panel had decided, this would not amount to a *de novo* review.[1581] After all, the Appellate Body reasoned that it 'is unreasonable to expect' the investigating authority to engage upon an enquiry as to whether other evidence would, by itself, sustain its finding. Indeed, 'it cannot be expected to proceed on the basis that certain aspects of its reasoning would later be found to be faulty'.[1582]

In sum, when an investigating authority has made a legal determination on the basis of a variety of factual findings, an assessment on the basis of a single piece of evidence would

[1575] Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 186.

[1576] Indeed, 'a Member may not seek to defend its agency's decision on the basis of evidence not contained in the record of the investigation'. Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, paras 161-165, 186.

[1577] In the words of the Appellate Body:

> 'when an investigating authority relies on the totality of circumstantial evidence, this imposes upon a panel the obligation to consider, in the context of the *totality* of the evidence, how the *interaction* of certain pieces of evidence may justify certain inferences that could not have been justified by a review of the individual pieces of evidence in isolation'.

Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 157 (emphasis in the original).

[1578] Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 188.

[1579] Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 154; Appellate Body Report, *Japan - DRAMs (Korea),* para 134.

[1580] Appellate Body Report, *Japan – DRAMs (Korea)*, paras 131-139.

[1581] Panel Report, *Japan – DRAMs (Korea)*, para 7.253.

[1582] Appellate Body Report, *Japan – DRAMs (Korea)*, para 133.

amount to a *de novo* review. On the other hand, the rejection of one of these findings should not preclude panels to *decide* on whether the remaining factual findings viewed in their totality suffice to reach the legal determination.[1583] Obviously, on a substantive level, those panels could still reach the conclusion that the remaining factual findings are insufficient to infer that assessment.[1584] In my view, the Appellate Body correctly concluded that this is not a *de novo* review because the remaining factual findings are made by the investigating authority and the panel is also not asked to alter the legal basis advanced by the investigating authority.[1585]

[1583] This conclusion holds unless this piece of evidence is considered by the authority as indispensable for its determination.

[1584] Appellate Body Report, *Japan – DRAMs (Korea)*, paras 135-137.

[1585] In essence, this is parallel to, for example, the Panel's conclusion in *EC - Countervailing Measures on DRAM Chips* whereby the Panel rejected part of the evidence advanced by the EC but still agreed that the remaining factors (in this case commercial unreasonableness and government's shareholdership) sufficed to infer government direction. See Panel Report, *EC – Countervailing Measures on DRAM Chips*, paras 7.130-7.131.

6. DIFFERENTIAL TREATMENT

The previous chapters in this Part discussed the general disciplines on subsidization and the imposition of CVDs set out under the SCM Agreement. However, these disciplines are not horizontally applicable to all countries or all goods. In this final chapter of Part II, the focus turns to the differential treatment for developing countries and agricultural goods. To some extent, both special regimes might be contrasted with each other, as the first was established on the demand of developing countries whereas the second was created on the demand of developed countries with a vulnerable agricultural industry. Of course, as amply illustrated in the historical overview,[1586] the division of interests toward agriculture does not fully correspond to the division between developed and developing countries. Whereas developed agriculture exporters such as Canada and Australia are firm proponents of liberalizing agriculture, net food-importing developing countries will be hurt by reduced subsidization in agriculture.

6.1. RATIONE PERSONAE: SPECIAL AND DIFFERENTIAL TREATMENT FOR DEVELOPING COUNTRIES

Article 27 of the SCM Agreement elaborates special and differential (S&D) treatment provisions for developing countries. As if it were a preamble, it declares that 'Members recognize that subsidies may play an important role in economic development programmes of developing countries'.[1587] The compliance Panel in *Brazil – Aircraft* read this as a reflection of the overarching concern recognized in the preamble to the WTO Agreement that:

> (…) there is need for positive efforts designed to ensure that developing countries, and especially the least-developed among them, secure a share in the growth in international trade commensurate with the needs of their economic development.[1588]

Nonetheless, the gradual extension of subsidy disciplines, in particular on export subsidies, is one of the main novelties of the SCM Agreement resulting mainly from US insistence during the Uruguay Round. In this section, we look into detail in the flexibility currently given to developing countries on subsidies as well as on CVDs.

[1586] See Figure 1 above Part II, Chapter 1, Section 1.5.
[1587] Article 27.1 of the SCM Agreement.
[1588] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, footnote 49.

6.1.1. Special and differential treatment on prohibited subsidies

6.1.1.1. Export subsidies

6.1.1.1.1. Least-developed countries and low-income countries listed in Annex VII

By virtue of Article 27.2(a) *juncto* Annex VII of the SCM Agreement, the disciplines on export subsidies contained in Article 3.1(a) do, in principle, not apply for two groups of developing countries: (i) least-developed countries (LDCs) designated as such by the United Nations[1589] and (ii) other low-income countries listed in Annex VII(b) until their gross national product (GNP) per capita has reached $1,000 per annum. The Doha Ministerial Conference decided to raise this threshold to $1,000 in constant 1990 dollars for three consecutive years.[1590] Regarding this second group, it should be emphasized that not all developing countries below this threshold could thus benefit from this S&D treatment but only those explicitly *listed* in Annex VII(b).[1591] All original WTO Members at the time of conclusion of the Uruguay Round with per capita income below the $1,000 were listed (with the omission of Honduras, which was added by a technical rectification).[1592] On the other hand, none of the acceding countries were superadded afterwards. Probably, countries deliberately opted for a closed list during the Uruguay Round so as to prevent that some of the later acceding countries, such as China, would be able to automatically benefit from this S&D treatment.[1593] As the following remark during Vietnam's accession negotiations painfully illustrates, not all acceding developing countries are apparently aware that they will not benefit from this exception if this is not negotiated:

> We understand that Vietnam considers that because it is a developing country with per capita GNP below US$1,000 it would be able to maintain export subsidies (...). This provision in the SCM is specific to developing countries referred to in Annex VII of the SCM. It is not a self-nominated or expanding list of countries. While we are prepared to consider some flexibility

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[1589] Annex VII(a) of the SCM Agreement. Out of 49 designated LDCs, 32 are currently WTO Member: Angola, Bangladesh, Benin, Burkina Faso, Burundi, Cambodia, Central African Republic, Chad, Congo, Democratic Republic of the Djibouti, Gambia, Guinea, Guinea Bissau, Haiti, Lesotho, Madagascar, Malawi, Maldives, Mali, Mauritania, Mozambique, Myanmar, Nepal, Niger, Rwanda, Senegal, Sierra Leone, Solomon Islands, Tanzania, Togo, Uganda, Zambia.

[1590] Moreover, Ministers agreed that the country in question will be re-included when its GNP per capita falls to less than $1,000. See *Ministerial Conference, Implementation Related Issues and Concerns* (WT/MIN(01)/17, 14 November 2001), paras 10.1 and 10.4.

[1591] As well as Honduras (see below n 1592).

[1592] By omission, the Annex VII(b) list in the latest draft of the SCM Agreement was not amended at the time Honduras became member before the final conclusion of the Uruguay Round. After years of requests by Honduras, the General Council finally allowed the Director-General to rectify this error in 2000. See *General Council, Implementation-Related Issues and Concerns, Decision of 15 December 2000* (WT/L/384, 19 December 2000); *General Council, Minutes of Meeting* (WT/GC/M/62, 28 February 2001), para 36.

[1593] To be sure, China's GNP per capita is currently higher than the $1,000 threshold but this could not have been foreseen at the time the Uruguay Round was concluded.

> on how Vietnam phases out its prohibited export subsidies, Vietnam has no right to recourse under these provisions to continue to provide prohibited subsidies following its accession.[1594]

Indeed, even though Vietnam's GNP per capita is currently still below the $1,000 dollar threshold, it does, similar to all non-original WTO Members,[1595] not benefit from this S&D treatment on export subsidies.[1596] In contrast, all low-income developing countries being original WTO Members can rely upon this flexibility until their GNP per capita reaches $1,000 in constant 1990 dollars for three consecutive years, as reflected in the most recent available data.[1597] Table 1 lists all these low-income counties and reveals that only three of them have graduated so far (i.e., Dominican Republic, Guatemala, and Morocco).

Together with all LDCs,[1598] these countries listed in Table 1 that did not graduate (e.g., Egypt, India, Indonesia) are thus exempted from the prohibition on export subsidies. The Ministers in Doha indeed emphasized (with regard to LDCs) that they 'have flexibility to finance their exporters, consistent with their development needs'.[1599] As elaborated below, two caveats are in place, however. First, this right to offer export subsidies extinguishes for products that have reached export competiveness. Second, export subsidies are not prohibited but could still be subject to an actionable subsidy claim and CVDs action.[1600]

	2005	2006	2007
Bolivia	771	798	841
Cameroon	936	933	954
Congo	834	--	871
Cote d'Ivoire	719	704	704
Dominican Republic	**1338**	**1459**	**1568**
Egypt, Arab Rep.	863	907	953

[1594] *Accession of Vietnam, Additional Questions and Replies* (WT/ACC/VNM/29, 30 October 2003), at 37. Vietnam finally acceded in 2007.

[1595] Other non-original WTO Members with GNP per capita of less than $1,000 in 1990 dollars include: Albania (2000), Armenia (2003), China (2001), Georgia (2000), Kyrgyz Republic (1998), FYR of Macedonia (2003), Moldova (2001), Mongolia (1997), Tonga (2007), Ukraine (2008). Hence, none of these countries can benefit from S&D treatment on export subsidies. See S. Creskoff and P. Walkenhorst, 'Implications of WTO Disciplines for Special Economic Zones in Developing Countries', *World Bank Policy Research Working Paper* (2009), 42 pp., at 24.

[1596] Even in current US$, Vietnam's GNI per capita is below the $1,000 threshold on the basis of the latest available data ($870 for 2008) (on the use of GNI instead of GNP, see below n 1602). See also, *Report of the Working Party on the Accession of Viet Nam* (WT/ACC/VNM/48, 27 October 2006), para 288.

[1597] The methodology for making this calculation is spelled out in the *Chairman's Report on the Implementation-related Issues Referred to the Committee at the Request of the Chairman of the General Council on 2 August and 15 October 2001 in the 15 December 2000 Decision of the General Council* (G/SCM/38, 26 October 2003), Appendix 2.

[1598] To be sure, also those LDCs that are non-original WTO Members benefit from this exception because Annex VII(a) is not a closed list: it exempts all LDCs 'designated as such by the United Nations which are Members of the WTO'.

[1599] Ministerial Conference, *Implementation Related Issues and Concerns* (WT/MIN(01)/17, 14 November 2001), para 10.5.

[1600] Article 27.7 of the SCM Agreement. See below on the scope of such actionable subsidy claims (Part II, Chapter 6, Section 6.1.2).

Ghana	536	557	580
Guatemala	**1060**	**1078**	**1150**
Guyana	782	846	830
Honduras	739	791	856
India	668	721	780
Indonesia	870	897	947
Kenya	385	392	410
Morocco	**1176**	**1323**	**1344**
Nicaragua	570	575	590
Nigeria	334	338	370
Pakistan	517	570	586
Philippines	975	999	1053
Senegal	850	837	862
Sri Lanka	821	885	916
Zimbabwe	422	--	--

TABLE 1: ANNEX VII(B) MEMBERS, GNI PER CAPITA AT CONSTANT 1990 DOLLARS, 2005-2007[1601,1602]

6.1.1.1.2. Small trading developing countries

All other developing countries were given eight years to phase out export subsidies (2003) but could request the SCM Committee, considering all their relevant economic, financial, and development needs, to extend this period (Article 27.4 of the SCM Agreement). The SCM Committee had to annually review the necessity of maintaining the export subsidies for which extension was granted. If the SCM Committee made a negative determination, the export subsidy had to be phased out within two years from the end of the last authorized period.[1603] A major disadvantage of this system was that the year-to-year extensions generated large uncertainty to developing countries' governments and their business community involved.[1604] Here again, the Doha Ministerial Conference (2001) provided some more flexibility without, however, extending the eight-year period in general. Only certain small trading developing

[1601] In full: *Note by the Secretariat, Annex VII(b) of the Agreement on Subsidies and Countervailing Measures, Updating GNP per Capita for Members Liisted in Annex VII(b) as Foreseen in Paragraph 10.1 of the Doha Ministerial Decision and in Accordance with the Methodology in G/SCM/38* (G/SCM/110/Add.6, 17 July 2009).

[1602] On the use of GNI (Gross National Income) instead of GNP (Gross National Product), the WTO Secretariat clarified that:

> 'The World Bank data series formerly identified as Gross National Product ("GNP") is now published as Gross National Income ("GNI"). This change reflects the implementation of the System of National Accounts 1993 ("SNA 93"). Although the underlying concepts are different (GNP being a measure of product, and GNI being a measure of income), the values calculated are the same'.

Seet, *Note by the Secretariat, Annex VII(b) of the Agreement on Subsidies and Countervailing Measures, Updating GNP per Capita for Members Listed in Annex VII(b) as Foreseen in Paragraph 10.1 of the Doha Ministerial Decision and in Accordance with the Methodology in G/SCM/38* (G/SCM/110/Add.6, 17 July 2009), footnote 1.

[1603] Article 27.4 of the SCM Agreement.

[1604] See R. A. Torres, 'Free Zones and the World Trade Organization Agreement on Subsidies and Countervailing Measures', 2:5 *Global Trade and Customs Journal* (2007), 217-223, at 221.

countries were granted,[1605] without a substantive review,[1606] annual extensions to 2007 for export subsidy programmes in force in 2001 that provided full or partial exemptions from import duties and internal taxes.[1607] Nevertheless, the level of subsidies still benefiting from this transitional period may not be raised (standstill obligation).[1608] This procedure was extended by the General Council in July 2007.[1609] Until the end of 2013, the SCM Committee shall continue these authorizations, subject only to an annual review of the transparency and standstill requirements. Consequently, their remaining export subsidies should be phased out no later than 31 December 2015.

In sum, this transitional flexibility to grant export subsidies currently only applies to certain small trading developing countries and only with respect to their listed programmes. These programmes relate to exemptions from import duties and internal taxes and are often implemented in export processing zones (EPZs).[1610,1611] Surely, this flexibility is relevant because such programmes mostly exempt firms located in EPZs from *direct* taxes and import duties on *capital* inputs.[1612] Hence, these measures go beyond the scope for such exemptions that would be allowed by virtue of footnote 1 of the SCM Agreement *juncto* the Illustrative List (items (e) and (i)).[1613]

The SCM Committee only annually reviews the transparency requirement and whether these programmes are not modified so as to make them more favourable (in terms of their scope, coverage, and intensity of benefits) than they were in September 2001 (standstill

[1605] This was open to developing countries whose share of world merchandise export trade was not greater than 0.10 per cent and whose gross national income (GNI) for the year 2000 was less than or equal to $20 billion. For the list of countries benefiting from this S&D treatment, see below n 1610. The Ministers instructed the SCM Committee to avoid different treatment for countries in similar circumstances. It must thus take into account relative competitiveness in relation to other developing countries that requested extension.
[1606] The annual review merely verifies transparency and standstill requirements (see below).
[1607] SCM Committee, *Procedures for Extensions under Article 27.4 for Certain Developing Country Members* (G/SCM/39, November 20, 2001).
[1608] Article 27.4 of the SCM Agreement. See Panel Report, *Brazil – Aircraft*, paras 7.58–7.67.
[1609] General Council, *Article 27.4 of the Agreement on Subsidies and Countervailing Measures* (WT/L/691, 31 July 2007).
[1610] These countries are (with the reference to their programmes eligible for continuation of extensions): Antigua & Barbuda (G/SCM/50/Add.7-51/Add.7); Barbados (G/SCM/52/Add.7-56/Add.7); Belize (G/SCM/57/Add.7-60/Add.7); Costa Rica (G/SCM/61/Add.7-62/Add.7); Dominica (G/SCM/63/Add.7); Dominican Republic (G/SCM/64/Add.7); El Salvador (G/SCM/65/Add.7); Fiji (G/SCM/66/Add.7-68/Add.7); Grenada (G/SCM/69/Add.7-71/Add.7); Guatemala (G/SCM/72/Add.7-74/Add.7); Jamaica (G/SCM/75/Add.7-78/Add.7); Jordan (G/SCM/79/Add.7); Mauritius (G/SCM/83/Add.7); Panama (G/SCM/84/Add.7-85/Add.7); Papua New Guinea (G/SCM/86/Add.7); St. Lucia (G/SCM/87/Add.7-89/Add.7); St. Kitts and Nevis (G/SCM/90/Add.7); St. Vincent and the Grenadines (G/SCM/91/Add.7) and Uruguay (G/SCM/92/Add.7).
[1611] See also Creskoff and Walkenhorst, above n 1595, at 23; Torres, above n 1604, at 221-222.
[1612] The obligation to export is often imposed to operate in such EPZs, which implies that such subsidies are contingent upon exportation.
[1613] See above Part II, Chapter 4, Section 4.1.1.2.2.

obligation).[1614] Yet, the same two caveats as with regard to Annex VII developing countries apply: extinction in case of export competitiveness and the possibility for actionable subsidy claims[1615] or CVDs responses by other WTO Members.

Before going into the first caveat, notice that four low-income countries listed under Annex VII(b) (i.e., Bolivia, Honduras, Kenya, and Sri Lanka)[1616] have preserved their right to similarly benefit from this transitional S&D treatment in case they would graduate before 2015.[1617] Hence, this means that those countries that have so far graduated under Annex VII(b) (i.e., Dominican Republic, Guatemala, Morocco) as well as non-original developing countries that acceded after the Doha Ministerial (2001) (e.g., Vietnam[1618]) cannot benefit from this transitional flexibility. From an equity point of view, this could be criticized given that these countries' GNI per capita might still be lower than (or similar to) the GNI per capita in 'small trading developing countries'. Politically, however, other WTO Members were only willing to extend the Article 27.4 flexibility to those countries that have an insignificant impact on trade, and thus a low potential to hurt their trading interests.[1619] Clearly, not all developing countries that are listed in Annex VII (e.g., India) or that recently acceded (e.g., Vietnam) have a small impact on trade.

6.1.1.1.3. Export competitiveness

The flexibility to offer export subsidies for these two groups of developing countries extinguishes for products that have reached export competitiveness. In that case, those export subsidies offered by the first group of developing countries ('Annex VII developing countries') have to be phased out within eight years.[1620] With regard to the second group of

[1614] For the procedure, see above n 1609, 1607. References to the SCM Committee decisions on continuing the extension of the transition period for the year 2010 can be found in *Report (2009) of the Committee on Subsidies and Countervailing Measures* (G/L/906, 26 October 2009), para 20, footnote 5.
[1615] Article 27.7 of the SCM Agreement.
[1616] See G/SCM/N/74/BOL & Suppl.1, G/SCM/N/74/HND, G/SCM/N/74/KEN, and G/SCM/N/74/LKA.
[1617] The date set for the standstill obligation refers to the year in which these Members' GNP per capita will reach the level $1,000 dollar in constant 1990 dollars. See *General Council, Article 27.4 of the Agreement on Subsidies and Countervailing Measures* (WT/L/691, 31 July 2007), para 4.
[1618] Again, other WTO Members explained this to Vietnam during accession negotiations: '(…) we do not consider that the provisions of Article 27.4 of the SCM Agreement available to developing countries, or the fast-track procedures under Article 27.4 for developing countries with a small share of world export trade agreed at the Doha Ministerial meeting, are available to Vietnam. Given that Vietnam will be acceding to the WTO after the completion of the implementation period for phasing out export subsidies for developing countries, we consider that Vietnam must phase out its export subsidy schemes upon accession'. *Accession of Vietnam, Additional Questions and Replies* (WT/ACC/VNM/29, 30 October 2003), at 37.
[1619] Recall also that the export competitiveness extinction is applicable in case such a country would, nonetheless, gain some relative importance in a trading sector. Moreover, the CVDs response also remains available to other countries (see below).
[1620] Article 27.5 of the SCM Agreement.

developing countries ('small trading developing countries'), export subsidies even have to be phased within two years after the establishment of export competitiveness.

According to Article 27.6 of the SCM Agreement, export competitiveness in a product exists 'if a developing country Member's exports of that product have reached a share of at least 3.25 per cent in world trade of that product for two consecutive calendar years'. The focus is therefore on the country's share in trade, not on its share in total production.[1621] Yet, such export competitiveness is only established, and the extinction period thus only kicks off, if this is either (a) notified by the developing country Member itself or (b) computed by the WTO Secretariat at the request of any other Member.[1622] As might be expected, the first track is never used because countries lack the incentive to notify such export competeveness themselves. This implies that the determination of export competitiveness *de facto* depends upon other Members' requests to the WTO Secretariat. With regard to 'Annex VII developing countries',[1623] only two such requests have been formulated so far. These were formulated by the US in 2003 and 2010 regarding India's export competitiveness on textile and apparel exports.[1624]

Before discussing the outcome of the 2010 WTO Secretariat computation, it should be highlighted that these computations have revealed interpretative difficulties regarding the exact coverage of the concepts 'world trade' and 'product' under Article 27.6 of the SCM Agreement. Both elements are explained in sequence.

First, does the concept of 'world trade' include trade between countries of the European Union (i.e., intra-EU(27) trade)? Because Article 27.6 contains 'no guidance' on this issue, the WTO Secretariat made calculations on the basis of excluding as well as including intra-EU(27) trade. Obviously, the required share in world exports is less easily met in case intra-EU trade is included. Therefore, developing countries support calculations made on this basis.[1625] This view should, in my opinion, be endorsed because the ordinary meaning of 'world trade' does not exclude trade between countries belonging to a customs union. This interpretation also preserves the recognized 'important role' of subsidies for developing

[1621] Hence, it excludes production for domestic consumption. See Panel Report, *US – Upland Cotton*, para 7.1441.

[1622] Article 27.6 of the SCM Agreement. The Secretariat only makes calculations according to the request of the WTO Member and does not interpret the results.

[1623] With regard to Article 27.4 countries, two requests and calculations have been made. See *Note from the Secretariat* (G/SCM/46, 7 August 2002) (on exports by Colombia, at the request of Ecuador); *Note from the Secretariat* (G/SCM/48, 16 October 2002) (on exports by Thailand, at the request of Ecuador and Peru).

[1624] These calculations can be found in G/SCM/132/Add.1, 23 March 2010; G/SCM/103/Add.1, 12 March 2003.

[1625] See, for instance, the results depicted in Table 2 included at the end of this Section. See, for example, *Replies of Cuba, Dominican Republic, Honduras, India, Indonesia, Malaysia, Pakistan, Tanzania, Uganda and Zimbabwe to Questions Raised Concerning the Proposal Contained in Document G/SCM/W/431/Rev.1 of 20 March 2001* (G/SCM/W/443, 17 May 2001), at 2.

countries (Article 27.1 of the SCM Agreement).[1626] After all, this object and purpose of S&D treatment in the framework of the SCM Agreement would be undermined if a developing country could, without increasing its own share in world exports, reach export competitiveness on the basis of the formation or extension of a customs union.

Second, the text of Article 27.6 of the SCM Agreement is ambiguous on whether products should be defined at either the section level or the heading level of the Harmonized System (HS) Nomenclature. With regard to the 2010 computation, the US therefore requested that this was undertaken at both the section level (i.e., Section XI of the HS Nomenclature on 'Textiles and Textile Articles') and the heading level (i.e., at the four digit-tariff level).[1627] The uncertainty flows from the definition of a 'product' in Article 27.6 as this refers to 'a section heading' of the HS Nomenclature, though the HS itself only contains 'sections' (group of chapters) or 'headings' (4-digit tariff level).[1628] Because they will more likely reach export competitiveness in a product defined at (the 4-digit) heading level than at the much broader section level,[1629] developing countries have generally pleaded for a product definition at the section level but no consensus has so far emerged in the SCM Committee.[1630] On the basis of contacts with participating delegates in the Uruguay Round, Hoda and Ahuja reveal that negotiators had in mind 'sections' and not 'headings'.[1631] Moreover, these authors likewise doubt whether it is feasible to operate export promotion schemes on a four-digit heading level, and thus to implement a prohibition on export subsidies if export competitiveness is defined at that level.[1632] After all, most exporters trade in products covering a number of different headings and it would be impractible to withdraw subsidies only for those in which export competitiveness has been demonstrated. On the other hand, the authentic French and Spanish texts of Article 27.6 refer to 'positions' and 'partidas' respectively, which correspond to four-digit 'headings' instead of 'sections'. According to Article 33(3) of the Vienna Convention, '(t)he terms of the treaty are presumed to have the same meaning in each

[1626] Recall that in *US – Softwood Lumber IV*, the Appellate Body confirmed that the SCM Agreement aims to strengthen GATT disciplines on the use of both subsidies and CVDs, 'while, recognizing at the same time, the right of Members to impose such measures under certain conditions' (see above n 559). Article 27.1 of the SCM Agreement seems to emphasize this right with regard to developing countries.
[1627] No request at the section level was made in the 2003 calculations.
[1628] The HS classification consists of 21 'sections', subdivided into 98 'chapters', and further subdivided into four-digit 'headings' and six-digit 'HS codes'. Tariff lines are defined at the six-digit level (or at further subdivisions).
[1629] See also Creskoff and Walkenhorst, above n 1595, footnote 56.
[1630] *Replies of Cuba, Dominican Republic, Honduras, India, Indonesia, Malaysia, Pakistan, Tanzania, Uganda and Zimbabwe to Questions Raised Concerning the Proposal Contained in Document G/SCM/W/431/Rev.1 of 20 March 2001* (G/SCM/W/443, 17 May 2001).
[1631] Hoda and Ahuja, above n 1088, at 1028. This is also mentioned by *Replies of Cuba, Dominican Republic, Honduras, India, Indonesia, Malaysia, Pakistan, Tanzania, Uganda and Zimbabwe to Questions Raised Concerning the Proposal Contained in Document G/SCM/W/431/Rev.1 of 20 March 2001* (G/SCM/W/443, 17 May 2001).
[1632] Hoda and Ahuja, above n 1088, at 1028.

authentic text'. The Appellate Body has confirmed that this customary rule of treaty interpretation implies that 'the treaty interpreter should seek the meaning that gives effect, simultaneously, to all the terms of the treaty, as they are used in each authentic language'.[1633] At first sight, this rule of treaty interpretation might rather point to products defined at the four-digit heading level because this seems the only 'simultaneous' ordinary meaning as used in each authentic language. Upon further scrutiny, it might, however, be questioned whether the ordinary meaning of 'a section heading' in the English text could indeed refer to a 'heading' in the meaning of the HS Nomenclature.[1634] Instead, the wording 'heading' could very well have been used in a generic, non-HS Nomenclature specific way in the phrase 'section heading'.[1635] In contrast to the other authentic texts, the English text might therefore rather refer to 'a section' under the HS nomenclature. Such discrepancy between different authentic texts would leave the meaning of a product ambiguous, in which case recourse to preparatory work as supplementary mean of interpretation should be taken (Article 32 of the Vienna Convention). This leads back to the interpretation of a product at the section level since this apparently was the drafters' intention.[1636]

Turning to the 2010 calculations made by the WTO Secretariat, India's export competitiveness was found not only on a large number of textile and apparel products at heading level but also at section level. The results at the section level are depicted in Table 2.

HS code		2003	2004	2005	2006	2007	2008
Section XI Textiles and textile articles	India's share in world including EU(27) trade	2.9%	2.9%	3.4%	3.4%	3.4%	3.6%
	India's share in world excluding EU(27) trade	3.8%	3.9%	4.3%	4.4%	4.3%	4.5%

TABLE 2: INDIA'S SHARE IN WORLD TRADE IN 'TEXTILES AND TEXTILE ARTICLES', INCLUDING AND EXCLUDING EU(27) TRADE[1637]

[1633] Appellate Body Report, *US – Softwood Lumber IV*, para 59. See also Appellate Body Report, *EC – Bed Linen (Article 21.5 – India)*, footnote 153; Panel Report, *China – Auto Parts*, para 7.165.
[1634] Indeed, to which element would the prefix 'section' exactly refer? Recall that sections in the HS Nomenclature are subdivided in 'chapters', which are only then subdivided into 'headings'.
[1635] Note in the margin that the WTO website also uses the phrase 'section heading' to refer to a 'section' of the HS Nomenclature.
Available at: http://www.wto.org/english/tratop_e/scm_e/scm_statindex_e.htm.
[1636] The 'object and purpose' to preserve subsidies as a development tool might also rather point to a product defined at the section level given that export competitiveness is less easily reached and phasing out export subsidies is more feasible if export competitiveness is reached.
[1637] This table is based on the computation by the WTO Secretariat (G/SCM/132/Add.1, 23 March 2010).

Table 2 indeed shows that, even when including intra-EU(27) trade, India has reached the required share of 3.25% for two consecutive calendar years (2005, 2006). If the section level is appropriate to define a 'product', India will have to gradually phase out its export subsidies on all textiles and textile articles over a period of eight years. This result illustrates the downside, from a developing country's perspective, of defining products at the section level. Although export competitiveness is indeed less readily present at this more aggregate level, it implies that all export subsidies on products under the broad section level will have to be phased out once such export competitiveness has been reached. Hence, export subsidies on those products for which export competitiveness not yet exists at the four-digit heading level will also fall under this prohibition.[1638]

This computation reveals a final interpretative difficulty under Article 27.6 (*juncto* 27.5[1639]) of the SCM Agreement. What is the exact starting point of the 8-years (or 2-years in case of small trading countries) extinction period? Export competitiveness was reached at the end of 2006 (on the basis of intra-EU(27) trade), whereas the WTO Secretariat computation was made in (March) 2010.[1640] Hence, should India phase out its export subsidies on textiles by the end of 2013 or by March 2017? The Doha Ministerial conference clarified that, with regard to LDCs[1641], the 8-years period 'begins from the date export competitiveness exists within the meaning of Article 27.6'.[1642] But this interpretation offers not much guidance. According to Article 27.6, export competitiveness 'exists' if the required share is reached. On the other hand, the same provision likewise stipulates that export competitiveness 'shall *exist*' on the basis of a notification or WTO Secretariat computation.[1643] The latter would suggest that export competitiveness would only exist once it has been established by a notification or WTO Secretariat computation. In my view, this moment should be considered the starting point of the extinction period. After all, deciding otherwise could imply that a developing country should have phased out export subsidies (long) before the computation has been

[1638] The calculations reveal that no export competitiveness, for example, exists for the product 'ties, bow ties and cravats' (HS code 6215). Yet, any existing export subsidy for this product will have to be phased out if export competitiveness is defined at the section level. India might thus now rather defend that such competitiveness should be defined at the four-digit product level.
[1639] This refers to a developing country which 'has reached export competitiveness'.
[1640] If the four-digit heading level would be relevant, export competitiveness for some products was already demonstrated under the 2003 calculations. In that case, the relevant question would be whether the starting point would be 2003 or the potential prior date when this export competitiveness was reached in the figures.
[1641] This also seems applicable with regard to other developing countries (e.g., India) because it interprets the current provisions rather than to give additional flexibility.
[1642] Ministerial Conference, *Implementation Related Issues and Concerns* (WT/MIN(01)/17, 14 November 2001), para 10.5
[1643] Emphasis added.

made, in which case it would thus forego the right to only *gradually* phase out these export subsidies.[1644,1645]

Next to the lack of clarity in the interpretation of the existing disciplines, developing countries have pointed to two fundamental flaws in the definition of export competitiveness as spelled in the current version of Article 27.6.[1646] First, the two year period to define export competitiveness is considered too short to neutralize increased market shares simply resulting from temporal, short-term fluctuations in the market.[1647] To ensure that export compettititiveness is not just reached because of temporary volatility of the market, a number of developing countries proposed to replace the current definition by a system of moving average.[1648] Export competitiveness in a certain year (Y5) would be calculated as an average of the share in exports over the last five years (Y1 + Y2 + Y3 + Y4 + Y5 / 5). Export competitiveness would be present only if such export shares would pass the 3.25 threshold for two consecutive years (e.g., Y5 and Y6).[1649] Second, a number of developing countries have criticized that the phase-out period starts without the option for re-inclusion if their exports would fall back under the 3.25% threshold.[1650] Here, some developing countries formally endorsed the 'stop-the-clock' mechanism initially suggested by the EC. If export competitiveness would be lost *during* the phase-out period, the clock would be stopped and

[1644] On the other hand, others might object that developing countries have an obligation to notify export competitiveness once it has been reached (and are thus – or should be – well aware thereof). Hence, in the absence of such notification, they should not complain when a computation by the WTO Secretariat is only made years later on the demand of another WTO Member.

[1645] This interpretation again gives weight to the recognition of subsidies as 'important' development tool (Article 27.1 of the SCM Agreement). Moreover, it would not make calculations of export competetiveness for previous years irrelevant (e.g., calculations in case of India were made for the period 1998-2008). After all, export competitiveness could be established on the basis of two previous consecutive years, in which case the extinction period would also start (at the moment of computation) even if the share of exports would fall back below the threshold in later years (see below).

[1646] For the initial discussion paper, see *Discussion Paper Submitted by Cuba, Dominican Republic, Honduras, India, Indonesia, Malaysia, Pakistan, Tanzania, Uganda and Zimbabwe* (G/SCM/W/431/Rev.1, 20 March 2001). For the formal proposal in the Rules negotiations, see *Submission by Egypt; India; Kenya; and Pakistan, Improvement and Clarification in Articles 27.5 and 27.6 of the ASCM Regarding Export Competitiveness* (TN/RL/GEN/136, 16 May 2006).

[1647] Developing countries referred to 'the volatility of the international market (i.e., international financial crisis, raise of the prices of petroleum, etc.) and the vulnerability of the developing countries to external influences, such as natural disasters'. *Discussion Paper Submitted by Cuba, Dominican Republic, Honduras, India, Indonesia, Malaysia, Pakistan, Tanzania, Uganda and Zimbabwe* (G/SCM/W/431/Rev.1, 20 March 2001), para 3.

[1648] *Submission by Egypt; India; Kenya; and Pakistan, Improvement and Clarification in Articles 27.5 and 27.6 of the ASCM Regarding Export Competitiveness* (TN/RL/GEN/136, 16 May 2006). The initial suggestion was to extend the period to five consecutive years. See, for example, *Minutes of the Special Meeting Held on 27 July 2001* (G/SCM/M/31, 5 February 2002), para 10.

[1649] The moving average share in Y6 equals Y2 + Y3 + Y4 + Y5 + Y6 / 5.

[1650] They referred, for instance, to the financial crisis in East Asian countries in the end of the 1999s. See, for example, *Discussion Paper Submitted by Cuba, Dominican Republic, Honduras, India, Indonesia, Malaysia, Pakistan, Tanzania, Uganda and Zimbabwe* (G/SCM/W/431/Rev.1, 20 March 2001), para 4; *Third Submission by India to the Negotiating group on Rules (Agreement on Subsidies and Countervailing Measures)* (TN/RL/W/120, 16 June 2003), para 10.

only re-start after export competitiveness is reached again. If export competitiveness would be lost *after* the phase-out period, export subsidies could be re-introduced until export competitiveness would be established for a second time, in which case a phase-out period of two years would start to run.

Whereas some developed countries seem to endorse the thrust of these proposals[1651], many other delegates have voiced their disagreement, with the US apparently taking the most defensive side.[1652] One might assume that developing countries not benefiting of S&D treatment on export subsidies would likewise not be keen to support more flexibility on export competitiveness, certainly because they might compete at a similar level of the product ladder.

In sum, WTO Members not only disagree on the interpretation of the current text (e.g., 'product' definition) but likewise on whether more flexibility should be inscribed. The functioning of the 'export competitiveness'-concept is even among the most controversial issues in the rules negotiations on the SCM Agreement.[1653] Instead of proposing a new draft text, the Chairman in the latest Draft Consolidated Chair Text could merely reproduce this divergence of views:

> Many delegations support in principle clarifying the provisions on the determination of export competitiveness in a product, but views differ considerably as to the best way to do this, including changing the period and/or methodology for calculating share of world trade in a product, or clarifying the definition of a "product" for this purpose. Views also differ widely as to whether reintroduction of export subsidies should be allowed if export competitiveness is lost after having been reached, and if so on what basis and for how long.[1654]

6.1.1.2. Local content subsidies

Developing countries are no longer benefiting from S&D treatment with regard to local content subsidies since the transitional period stipulated under Article 27.3 of the SCM Agreement has expired.

In principle, flexibility for local content subsidies would be anyway less meaningful because Article III:4 of the GATT and the TRIMs Agreement seem to outlaw these subsidies. Yet, the TRIMs Agreement still offers limited S&D treatment on trade-related investment measures,

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[1651] See, for instance, *Comments of Switzerland* (G/SCM/W/450, 29 May 2001).

[1652] See, for example, *Replies of Cuba, Dominican Republic, Honduras, India, Indonesia, Malaysia, Pakistan, Tanzania, Uganda and Zimbabwe to Questions Raised Concerning the Proposal Contained in Document G/SCM/W/431/Rev.1 of 20 March 2001* (G/SCM/W/443, 17 May 2001); *Replies of Cuba, Dominican Republic, Honduras, India, Indonesia, Malaysia, Pakistan, Tanzania, Uganda, and Zimbabwe to Questions from the United States* (G/SCM/W/448, 22 May 2001).

[1653] See also Negotiating Group on Rules, *Working Document from the Chairman, Annex B – Subsidies and Countervailing Measures* (TN/RL/W/232; 28 May 2008), at B-8.

[1654] Draft Consolidated Chair Text, above n 643.

such as local-content requirements.[1655] In general, developing countries that have notified their measures inconsistent with the TRIMs Agreement after the entry into force of the WTO Agreement[1656] could still uphold these if the transitional period is extended by the Council for Trade in Goods.[1657] Regarding LDCs, the Hong Kong Ministerial Declaration even allowed to maintain, at least until the end of 2012, existing notified measures that deviate from the TRIMs Agreement as well as to introduce new measures, to which the Council for Trade in Goods would give 'positive consideration'.[1658]

However, developing countries are not allowed to make the receipt of a subsidy conditional upon a local content requirement, even if such an investment measure would still benefit from S&D treatment under the TRIMs Agreement. Indeed, the Panel in *Indonesia – Autos* concluded that the obligations under both agreements apply cumulatively.[1659] Examining the relationship between the TRIMs Agreement and Articles 3.1 *juncto* 27.3 of the SCM Agreement, the Panel in *Indonesia – Autos* held:

> To respond to an argument raised by Indonesia in the context of its discussion of the relationship between Article III of GATT and the SCM Agreement, we do not consider that the application of the TRIMs Agreement to this dispute would reduce the SCM Agreement, and Article 27.3 thereof, to "inutility". On the contrary, with Article 27.3 of the SCM Agreement, those *subsidy measures of developing countries that are contingent on compliance with TRIMs (in the form of local content requirement)* and that are permitted during the transition period provided under Article 5 of the TRIMs Agreement, are not prohibited by Article 3.1(b) of the SCM Agreement, *for the transition period specified in Article 27.3 of the SCM Agreement*.[1660]

Given that the transition period under the SCM Agreement has lapsed by now, the scope of the remaining S&D treatment in place under the TRIMs Agreement is somewhat reduced.[1661]

[1655] See Article 5 of the TRIMs Agreement (Article 4 is less relevant for our discussion). Regarding disciplines on local content requirements, see Article 2 *juncto* Annex, para 1 of the TRIMs Agreement.
[1656] Or after accession.
[1657] It takes into account the individual development, financial and trade needs of the Member in question (Article 5.1 *juncto* 5.3 of the TRIMs). For a list of notifications, see *Draft (2009) of the Committee on Trade-Related Investment Measures* (G/L/900, 21 October 2009), Annex I.
[1658] Again, taking into account the individual financial, trade, and development needs of the Member in question. The duration of these measures will not exceed five years, renewable subject to review and decision by the Council for Trade in Goods. *Hong Kong Ministerial Declaration* (WT/MIN(05)/DEC, 22 December 2005), Annex F.
[1659] Panel Report, *Indonesia – Autos*, paras 14.47-14.55.
[1660] Panel Report, *Indonesia – Autos*, para 14.54 (emphasis added). On the link between Article III GATT and the SCM Agreement, see also paras 14.97-14.101.
[1661] This corresponds somewhat to the situation under the Dunkel Draft circulating in the Uruguay Round. S&D treatment was stipulated under the TRIMs Agreement, whereas no corresponding S&D treatment was installed under this draft of the SCM Agreement. According to the US in *Indonesia – Autos*, Article 27.3 exactly aimed to remedy this situation. Yet, it lapsed before the extended S&D treatment under the TRIMs Agreement. See Panel Report, *Indonesia – Autos*, paras 5.338-5.339.

Local content requirements installed by developing countries benefiting from such S&D treatment could not be conditioned on subsidies.[1662]

6.1.2. Special and differential treatment on actionable subsidies

Within the limits set out in this section, actionable subsidy claims could in principle be articulated against all specific subsidies offered by a developing country Member.[1663] Yet, at the end of this section, it will be examined whether this S&D treatment on actionable subsidies is also available with regard to *export subsidies* that are not prohibited by virtue of S&D treatment set out above.[1664]

This S&D treatment on actionable subsidies is in principle available to all 'developing country' Members, which is a self-selected status that could be challenged by other WTO Members.[1665] However, an exception has to be made with regard to China. When it acceded to the WTO, China committed not to rely on the S&D treatment on actionable subsidies (Articles 27.8, 27.9 and 27.13 of the SCM Agreement).[1666] Since it is likewise excluded from S&D treatment on prohibited subsidies, China's multilateral disciplines on subsidies correspond to those of developed countries. China only explicitly preserved its right to benefit from S&D treatment for developing countries regarding CVDs, which is examined in the following section.[1667]

What is the scope of developing countries' S&D treatment on actionable subsidies? By virtue of Article 27.9 of the SCM Agreement, not all three forms of adverse effects singled out under Article 5 of the SCM Agreement can be invoked against subsidies offered by developing countries. 'In the usual case',[1668] other Members can only proceed against *injury* to their domestic industry as well as against *nullification or impairment* of tariff concessions

[1662] Notice that the Panel in *Indonesia – Autos* observed that 'under the TRIMs Agreement, the advantage made conditional on meeting a local content requirement may include a wide variety of incentives and advantages, other than subsidies'. Panel Report, *Indonesia – Autos*, para 14.51.
[1663] Recall that the Panel in *Korea – Commercial Vessels* also left open the possibility that even prohibited subsidies could be challenged as an 'actionable subsidy'.
[1664] Article 27.7 of the SCM Agreement. See also Panel Report, *Indonesia – Autos*, para 14.169.
[1665] Note that there was no disagreement among the parties in *Indonesia – Autos* that Indonesia was a developing country entitled to S&D treatment under Article 27.9 of the SCM Agreement. Likewise, all parties in *Brazil – Aircraft* agreed that Brazil was a developing country within the meaning of the SCM Agreement. See Panel Report, *Indonesia – Autos*, para 14.157; Panel Report, *Brazil – Aircraft*, para 7.38.
[1666] See *Report of the Working Party Report on the Accession of China* (WT/ACC/CHN/49), para 171. See also *Minutes of the Regular Meeting Held on 29 October 2008* (G/SCM/M/66, 14 April 2009), paras 98-99.
[1667] Yet, not all countries (e.g., US) consider China as a developing country under their CVDs procedures (see below Part II, Chapter 6, Section 6.1.3).
[1668] Panel Report, *Indonesia – Autos*, para 14.156.

or other GATT obligations undertaken by the subsidizing developing country.[1669] In essence, this corresponds to the two first types of adverse effects set out under Article 5 of the SCM Agreement (paragraphs (a) and (b)).[1670]

Complaints on the basis of *serious prejudice* (Article 5(c) of the SCM Agreement), which is the broadest form of adverse effects, are less evident and might even be impossible today according to some authors. To understand this discussion, Article 27.8 and Article 27.9 have to be read together. By virtue of Article 27.8, the presumption of serious prejudice formulated in Article 6(1) of the SCM Agreement could not be invoked against developing countries, but WTO Members can nevertheless demonstrate by positive evidence[1671] that serious prejudice is caused in those four cases.[1672] Further, Article 27.9 clarifies that other cases of serious prejudice caused by subsidizing developing countries can surely not be challenged:

> Regarding actionable subsidies granted or maintained by a developing country Member *other than those referred to in paragraph 1 of Article 6*, action may not be authorized or taken under Article 7 unless (nullification or impairment of GATT obligations or injury to the domestic industry).[1673]

As the presumption in Article 6.1 expired at the end of 1999, the S&D treatment on this presumption articulated in Article 27.8 no longer has legal implications. More important nowadays is, however, the question whether the four cases of subsidies opening the door to a serious prejudice claim have likewise disappeared as a result of the expiration of Article 6.1. Surprisingly, this issue was left undiscussed by WTO Members at the time the debate on the extension of Article 6.1 was undertaken (1999). The literature has been divided on this question.

On the one hand, Hoda and Ahuja hold that the expiration of Article 6.1 has indeed the legal consequence that action against developing countries on the basis of the four cases of serious prejudice is excluded. Hence, developing countries may not be subject to a claim that their subsidies have caused serious prejudice.[1674] These authors' argument is that, with the expiration of Article 6.1,[1675] 'the list of measures in respect of which serious prejudice applied earlier to developing country Members (Article 27.9) has also disappeared'.[1676] In one of the scarce references in the WTO negotiations regarding this issue, Canada listed Article 27.9 as

[1669] Such nullification or impairment has to impede or displace imports of a like product of another Member into the market of the subsidizing developing country Member.
[1670] See above Part II, Chapter 4, Section 4.2.
[1671] In accordance with paragraphs 3 through 8 of Article 6 of the SCM Agreement.
[1672] Article 27.8 of the SCM Agreement.
[1673] Emphasis added.
[1674] Hoda and Ahuja, above n 1088, at1029; see also Torres, above n 1604, at 219, footnote 19.
[1675] Indeed, according to Article 31 of the SCM Agreement, Article 6.1 of the SCM Agreement *as such* has expired.
[1676] Hoda and Ahuja, above n 1088, at 1029.

one of the provisions that was 'affected by the lapsing of Article 6.1'.[1677] This would suggest that it implicitly endorsed this first interpretation.

On the other hand, Clarke and Horlick hold that the expiration of the presumption did likely not alter the four cases upon which serious prejudice can be based.[1678] They explain that 'since the presumption of serious prejudice arising in Article 6.1 never applied to developing countries, it could be argued that the definitional aspect of Article 6.1 still applies, in order to raise a serious prejudice complaint against a developing country Member'.[1679] They seem to argue that a claim of serious prejudice in case of developing countries is not based on Article 6.1 of the SCM Agreement but on Article 27.9 (and 27.8) of the SCM Agreement and that this provision only *refers* to the four cases of serious prejudice under Article 6.1 of the SCM Agreement. By referring to Article 6.1, Article 27.9 of the SCM Agreement would incorporate those four cases of serious prejudice but would not be dependent upon its application. The fact that Articles 27.8 and 27.9 were not advanced by either developing or developed countries as a relevant element in the debate on the expiration of Articles 6.1 and 8 of the SCM Agreement might tentatively suggest that WTO Members endorsed this reading. This interpretation would mean that, in addition to injury to the domestic industry and nullification or impairment, adverse effects could still be shown on the basis of 'serious prejudice' if one of the four situations spelled out in Article 6.1 of the SCM Agreement is present:

> (a) the total ad valorem subsidization of a product exceeding 5 per cent;
> (b) subsidies to cover operating losses sustained by an industry;
> (c) subsidies to cover operating losses sustained by an enterprise, other than one-time measures which are non-recurrent and cannot be repeated for that enterprise and which are given merely to provide time for the development of long-term solutions and to avoid acute social problems;
> (d) direct forgiveness of debt, i.e. forgiveness of government-held debt, and grants to cover debt repayment.[1680]

Once a complainant has demonstrated the existence of one of these four types of subsidies, it will subsequently have to advance positive evidence that these subsidies cause serious

[1677] After all, the lapse of Article 6.1 would have no legal implications for the operation of Article 27.9 of the SCM Agreement if the alternative interpretation is endorsed. See *Communication from Canada* (TN/RL/GEN/112/Rev.1, 17 May 2006).
[1678] See Clarke and Horlick, above n 587, at 728–729. Along the same lines, see F. Piérola, 'Article 6 SCMA', in R. Wolfrum, P-T. Stoll, and M. Koebele (eds), *WTO: Trade Remedies* (Heidelberg: Max Planck Institute for Comparative Public Law and International Law, 2008), 498-536, at 509. Luengo even argued that all types of 'serious prejudice' are now challengeable with regard to developing countries. Yet, this interpretation seems certainly incorrect in light of Article 27.9 of the SCM Agreement. See Luengo, above n 771, at 203.
[1679] See Clarke and Horlick, above n 587, at 728–729
[1680] Footnotes omitted. Footnote 14 to Article 6.1(a) indicates that the total ad valorem subsidization shall be calculated in accordance with Annex IV of the SCM Agreement, which indicates that the subsidy amount shall be based on the cost to the government. See also *Note from the Informal Group of Experts – Revisions* (G/SCM/W/415/Rev.2, 15 May 1998).

prejudice by generating the price/volume effects set out in Article 6.3 of the SCM Agreement.[1681] This two-steps approach was applied by the Panel in *Indonesia – Autos*, dating from before the expiration of Article 6.1 of the SCM Agreement. Having revealed that parties agreed that an *ad valorem* subsidy exceeding 5 per cent was offered (Article 6.1(a) of the SCM Agreement), the Panel examined whether the complainants demonstrated that these subsidies caused 'serious prejudice' in the meaning of Article 6.3 of the SCM Agreement.[1682] Noteworthy, the Panel underlined that the 'developing country'-status does not impose a higher burden of proof upon complainants to show such 'serious prejudice' under the second step.[1683]

Although both interpretations are thus plausible, I would expect that a panel confronted with this inquiry would foreclose such serious prejudice claim since the expiration of Article 6.1 of the SCM Agreement and would rather opt for the restrictive reading of Article 27.9 of the SCM Agreement as suggested by Hoda and Ahuja.[1684]

So as to stimulate privatization programmes, direct forgiveness of debts and subsidies to cover social costs when 'granted within and directly linked to' privatization can never be challenged as actionable subsidies (Article 27.13 of the SCM Agreement).[1685] To benefit from this exception, these subsidies should be granted for a limited time period and notified to the SCM Committee, and the programme should result in eventual privatization of the

[1681] Or a threat of serious prejudice. See above Part II, Chapter 4, Section 4.2.3.

[1682] The Panel rejected the claim of displacement or impediment in the subsidizing market (Article 6.3(a) of the SCM Agreement) but accepted the claim of price undercutting (Article 6.3(c) of the SCM Agreement) (see above Part II, Chapter 4, Section 4.2.3.3).

[1683] The Panel held that the term 'positive evidence' in Article 27.8 is followed by 'in accordance with the provisions of paragraphs 3 through 8 of Article 6'. The term 'positive evidence' refers to the difference with the 'presumption' of serious prejudice upon developed countries. See Panel Report, *Indonesia – Autos*, para 14.169.

[1684] First, the text of Article 31 of the SCM Agreement refers to the temporary application of '(t) *provisions of paragraph 1 of Article 6* and the provisions of Article 8' (emphasis added). Hence, it not merely refers to the presumption elaborated in Article 6.1 of the SCM Agreement. Second, the text of Article 27.9 of the SCM Agreement refers to 'actionable subsidies (…) referred to in paragraph 1 of Article 6' and, therefore, seems dependent upon the existence of this provision. The alternative reading suggested by Horlick and Clarke is possible but would be more difficult to align to the wording of this text. Third, the restrictive interpretation articulated by Hoda and Ahuja would mean that the extinction of Article 6.1 of the SCM Agreement not only relaxed disciplines on domestic subsidies for developed countries (as the presumption of serious prejudice under Article 6.1 of the SCM Agreement collapsed) but likewise for developing countries. This is justified given that the status of Article 6.1 of the SCM Agreement was, at least in political terms, bound to the status of the green light category. In a sense, the collapse of Article 6.1 of the SCM Agreement should thus compensate both developed and developing countries for more restrictive disciplines on green light subsidies. Fourth and finally, a restrictive reading might find contextual support in Article 27.1 of the SCM Agreement, which underscores the important role that subsidies may play in economic development programmes of developing countries.

[1685] Hence, pre-privatization subsidies that are not 'granted within and directly linked' to privatization fall outside the scope of this provision. See Panel Report, *US – Lead and Bismuth II,* footnote 86.

enterprise concerned.[1686] Until present, only one such privatization programme has been notified, namely by Brazil in 1996 concerning the privatization of state companies in a number of different industries.[1687] To be sure, such privatization programmes are only shielded from actionable subsidy claims and not from the imposition of CVDs or from prohibited subsidy claims. The latter implies that export subsidies and local content subsidies cannot be justified on this basis.[1688]

Before concluding, the inquiry has to be solved whether the S&D treatment on actionable subsidies as sketched out in this section is also available regarding challenges against *export subsidies* that are *not prohibited* by virtue of S&D treatment.[1689] According to most authors, this is not the case. Such export subsidies can be challenged on the basis of the actionable subsidy disciplines similarly as with regard to developed countries. This means that 'serious prejudice' can be demonstrated simply on the basis of Article 6.3 of the SCM Agreement.[1690,1691] Likely, their interpretation is based on the text of Article 27.7 of the SCM Agreement, which refers to the remedies for actionable subsidies singled out under Article 7:

> The provisions of Article 4 shall not apply to a developing country Member in the case of *export subsidies* which are in conformity with the provisions of paragraphs 2 through 5. *The relevant provisions in such a case shall be those of Article 7*.[1692]

On the other hand, Article 27.7 might be read together with the relevant parts of Article 27.9 of the SCM Agreement, which spells out S&D treatment on actionable subsidies:

> Regarding *actionable subsidies* granted or maintained by a developing country Member other than those referred to in paragraph 1 of Article 6, action may *not* be authorized or taken under *Article 7* unless (nullification or impairment or injury to the domestic industry).[1693]

Putting both provisions together, the unsettled query is whether claims against non-prohibited[1694] 'export subsidies' under Article 7 are limited to those situations spelled under

[1686] Article 27.13 of the SCM Agreement.
[1687] This included the petrochemical industry and infrastructure (e.g., electrical power plants, transportation service, and communication systems). In some cases, the government undertook prior financial streamlining of the state enterprises involved (e.g., underwriting of debt) but Brazil also emphasized that it considered that no subsidization was *in fact* involved in these operations. See *Communication from Brazil, Notification on Privatization Programmes pursuant to Article 27.13 of the Agreement* (G/SCM/N/13/BRA, 12 March 1996).
[1688] This was also confirmed by the Panel in *US – Lead and Bismuth II* (para 6.76).
[1689] See above Part II, Chapter 6, Section 6.1.1.1.
[1690] Hoda and Ahuja, above n 1088, at 1028, 1058, 1059. This also seems the position of Benitah, above n 893, at 39.
[1691] Interestingly, also Brazil seemed to adopt this position before the Panel in *Brazil – Aircraft*. Because it benefited (at that time) from S&D treatment on export subsidies, Brazil claimed that Canada had to pursue the remedies set out in Article 7 of the SCM Agreement. Brazil did not explicitly limit these remedies to the trade impacts challengeable under Article 27.9 of the SCM Agreement. Panel Report, *Brazil – Aircraft*, para 4.156
[1692] Emphasis added.
[1693] Emphasis added.

Article 27.9 of the SCM Agreement.[1695] A careful reading of *Indonesia – Autos* reveals that the Panel cautiously circumvented this issue with respect to local content subsidies offered by Indonesia. Note that S&D treatment on such local content subsidies was still in place at that time (Article 27.3 of the SCM Agreement). Somewhat counterintuitive, both complainants (EC and US) considered that Indonesia as developing country could only be subject to a serious prejudice claim in case its local content subsidies were covered by one of the situations under Article 6.1 of the SCM Agreement.[1696] For instance, the EC read Article 27.9 as mandating that 'where *a subsidy* is granted by a developing country Member, "serious prejudice" can only be invoked if the subsidy in question falls within one of the categories "referred to" in Article 6.1 of the SCM Agreement'.[1697] Indonesia, on the other hand, claimed that, by virtue of Article 27.7,[1698] a 'serious prejudice' claim could in addition be directly formulated under Article 5 and 6 of the SCM Agreement if export subsidies or local content subsidies are offered. The Panel accepted that non-prohibited local content subsidies *could* certainly be considered 'actionable subsidies' in the meaning of Article 27.9 of the SCM Agreement, in which case the burden of Article 6.1 *has* to be passed.[1699] Nonetheless, the Panel explicitly left undecided whether a 'serious prejudice'-claim could, as argued by Indonesia, also be directly based on Articles 5 and 6 of the SCM Agreement in case subsidies qualify as local content or export subsidies.[1700]

In light of the Panel's conclusion in *Korea – Commercial Vessels* that even export subsidy could be challenged as an actionable subsidy,[1701] one might suggest that the term 'actionable subsidies' in Article 27.9 includes 'export subsidies'. Depending on the reading of Article 27.9 *juncto* 6.1 of the SCM Agreement, this interpretation would either exclude 'serious prejudice'-claims against permitted export subsidies or limit the relevant 'serious prejudice'-provisions to those four situations spelled out in Article 6.1 of the SCM Agreement. However, if one would take the negotiating history into consideration, he would rather concur with those scholars holding that claims against export subsidies benefiting from S&D treatment are likely not constrained by Article 27.9 of the SCM Agreement. First, the corresponding provision under the Subsidies Code referred to 'any subsidy, other than an export subsidy'.[1702] The replacement by 'actionable subsidies' in the current text seems to

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[1694] These are not prohibited by virtue of S&D treatment.
[1695] Recall that the 'serious prejudice' claims might no longer be possible today.
[1696] Panel Report, *Indonesia – Autos*, paras 8.53, 8.90.
[1697] Panel Report, *Indonesia – Autos*, para 8.53 (emphasis added).
[1698] According to Indonesia, Article 27.7 also covered local content subsidies, even though its text explicitly refers to 'export subsidies'.
[1699] This panel report dates from before the expiration of Article 6.1 of the SCM Agreement. Panel Report, *Indonesia – Autos*, paras 14.156-14.162.
[1700] Panel Report, *Indonesia – Autos*, footnote 724.
[1701] Panel Report, *Korea – Commercial Vessels*, para 7.334.
[1702] See Article 14:7 of the Subsidies Code.

aim at implementing the new traffic light approach rather than at substantively modifying its scope and seems therefore not intended to cover 'export subsidies'. Second, developing countries signatories already agreed under the Subsidies Code that their export subsidies would not be used in a manner which caused serious prejudice to other signatories of the Subsidies Code.[1703] Given that one of the prime aspirations of developed countries was to strengthen these disciplines during the Uruguay Round, it seems unlikely that the negotiators intended to limit this obligation under the SCM Agreement.[1704] Therefore, it seems probable that, by virtue of Article 27.7 of the SCM Agreement, export subsidies benefiting from S&D treatment are actionable under Article 5 and 6 of the SCM Agreement and do not benefit from the S&D treatment on actionable subsidies set out in this section.

6.1.3. Special and differential treatment on countervailing duties

The S&D treatment provisions described in the previous sections do not restrict the use of CVDs *against* developing countries but merely have an impact on the use of multilateral remedies. Indeed, the limited exemptions regarding disciplines on prohibited and actionable subsidies do not exclude that Members impose CVDs to offset subsidies from developing countries causing injury to their domestic industry. Only Article 27.10 of the SCM Agreement provides for S&D treatment by raising the *de minimis* standard in case CVDs action is considered against products originating from developing countries. These CVDs investigations should be terminated if the overall level of subsidies is less than 2 per cent *ad valorem* (in contrast to 1 per cent otherwise by virtue of Article 11.9 of the SCM Agreement)[1705] or if the volume of subsidized imports is less than 4 per cent of the total imports. Yet, the four per cent volume exception (i.e., *de minimis* volume threshold) does not apply if imports from developing countries whose individual shares are less than 4 per cent collectively account for more than 9 per cent of total imports.[1706] Similar to the general *de minimis* subsidy benchmark formulated under Article 11.9, this S&D treatment is, according

[1703] Article 14 of the Subsidies Code.
[1704] On the other hand, one might object that those developing countries still benefiting from an exception on export subsidies were often not party to the plurilateral Subsidies Code and that the possibility to challenge such export subsidies was much more difficult under the Subsidies Code.
[1705] Article 27.11 of the SCM Agreement provided for a 3 per cent *de minimis* threshold for (i) Annex VII developing countries and (ii) other developing countries (Article 27.2(b)) that had phased out their export subsidies before the eight years phase out period. Yet, it was explicitly stipulated that 'this provision shall expire eight years from the date of entry into force of the WTO Agreement'. Nonetheless, Mavroidis, Messerlin, and Wauters suggest that Annex VII developing countries could still benefit from this exception because the eight years period seems linked to the other developing countries' phase out period for export subsidies. In my view, however, the text of Article 27.11 leaves no room for such an interpretation as it clearly stipulates that it expires in 2003. See Mavroidis, Messerlin, above n 729, at 374, footnote 3.
[1706] Article 27.10 of the SCM Agreement.

to the Appellate Body in *US – Carbon Steel*, only applicable in the original CVDs 'investigation' and not in sunset reviews.[1707]

Clarke and Horlick explain that this S&D treatment is intended to prevent developing countries from a costly defense in case their exports merely represent a marginal share of the market. Yet, regarding the *de minimis* volume threshold, they correctly criticize the '9 per cent collective share of total imports'-exception because developing countries could obviously not control for the exports of other countries.[1708] Moreover, given their large number in the WTO, developing countries might collectively rather easily pass the 9 per cent of total imports threshold (e.g., 5 countries having a share of 2 per cent each).[1709]

In principle, all 'developing countries' benefit from this S&D treatment when trading partners aim at imposing CVDs on their subsidized imports. Because CVDs are imposed unilaterally, the initial decision to assign the status of 'developing country' under Article 27.10 is however made by the importing country. For instance, the US does not recognize China and Vietnam as developing countries in its CVDs investigations,[1710] which could be challenged by both countries before the WTO dispute settlement system. Recall that Vietnam and China even seem more vulnerable to CVDs (and anti-dumping) actions than all other countries. As explained, CVDs-investigating authorities could easier rely on foreign prices as relevant benchmark in calculating the benefit amount.[1711]

In the beginning of the Doha Round, India had proposed a double extension of the S&D treatment set out in Article 27.10 of the SCM Agreement.[1712] First, it suggested adding the obligation that CVDs could be imposed against imports of developing countries only to that amount by which the subsidy exceeds the *de minimis* subsidy level. Second, the *de minimis* volume threshold should be increased from 4 per cent to 7 per cent. The latter proposal would have the advantage that exporters are not required to expend resources for participating in the CVDs investigation. Moreover, both proposals would result in fewer impositions (or lower levels) of CVDs against developing countries and thus recognize the importance of subsidization as a development tool. Yet, the absence of further discussions on these proposals after 2003 as well as the fact that the latest Draft Negotiating Text does not include any amendment on Article 27.10 seems to show that there is not much support to modify Article 27.10 along these lines.

[1707] See Appellate Body Report, *US – Carbon Steel*, para 82.
[1708] Clarke and Horlick, above n 587, at 729.
[1709] On the other hand, WTO Members might be reluctant to start such costly and complicated CVDs procedure against a large number of countries.
[1710] Gantz, above n 828, at 7.
[1711] See above Part II, Chapter 3, Section 3.2.1.2.
[1712] See *Submission by India* (TN/RM/W/4, 25 April 2002); *India's Replies to Questions from the United States on its Submissions (TN/RL/W/4 and TN/RL/W/26)* (TN/RL/W/99, 3 May 2003).

Despite the S&D treatment regarding the imposition of CVDs on imports from developing countries, Table 3 illustrates that the majority of CVDs actions have targeted their imports since the birth of the WTO.[1713,1714]

Exporting country subject to CVDs action	CVDs initiations	CVDs measures
India	46	28
China	29	17
European Communities	10	9
Italy	13	9
Brazil	7	8
Korea	17	8
Indonesia	11	7
France	7	6
Argentina	7	4
South Africa	6	4

TABLE 3: TOP 10 EXPORTING COUNTRIES SUBJECT TO CVDS MEASURES AND CVDS INITIATIONS OVER THE PERIOD 1 JANUARY 1995 – 30 JUNE 2009[1715,1716]

One third of all CVDs measures imposed to date are installed on imports from India and China, but also other larger developing countries are regularly subject to CVDs actions.[1717] Because China only recently became submitted to CVDs investigations given its non-market economy status, it is expected that it will soon replace India as the main target of CVDs action. As an indication, over the period 2008-June 2009, no less than sixteen CVDs investigations were launched against China, compared to only two against India.[1718] So far,

[1713] Note that these figures might be incomplete as they are based on notifications by WTO Members. WTO Members are obliged to submit information on the following CVDs actions: (1) initiations; (2) preliminary determinations/provisional measures; (3) final determinations/definitive measures. See Article 25.11 of the SCM Agreement and the procedure spelled out in G/SCM/3/Rev.1 (2 November 2009).
[1714] The World Trade Report 2009 calculated that developing countries were the subject of 66% of all CVDs initiations and 61% of all CVDs measures. See WTO Secretariat, *World Trade Report 2009 – Trade Policy Commitments and Contingency Measures* (Geneva: WTO Publications, 2009), 171 pp., at 140.
[1715] WTO Secretariat statistics based on notifications by WTO Members. Available at: http://www.wto.org/english/tratop_e/scm_e/cvd_init_exp_country_e.pdf. http://www.wto.org/english/tratop_e/scm_e/cvd_meas_exp_country_e.pdf.
[1716] The reason why, in case of Brazil, the number of CVDs measures is higher than the initiated number is that no notifications were made for CVDs initiations launched before 1995 resulting in CVDs measures imposed after 1 January 1995.
[1717] Most CVDs actions were taken against their exports falling under Section XV of the Harmonized System ('Base metals and articles of base metals'). Other Indian products often targeted are covered under Sections VI and VII ('Products of the chemical or allied industries'; 'Plastics and articles thereof; rubber and articles thereof'). Regarding the sectoral pattern of contingency measures, see also World Trade Report 2009, above n 1714, at 136-137.
[1718] WTO statistics: http://www.wto.org/english/tratop_e/scm_e/cvd_init_rep_member_e.pdf.

all definitive CVDs measures against China were imposed by the US and Canada.[1719] The US and EC are mainly responsible for the high level of CVDs actions against India.[1720]

Table 4 lists all WTO Members that have imposed at least one CVDs measure over the period 1995 - June 2009.[1721] Note that the substantive and detailed procedural requirements to undertake CVDs action are not relaxed with regard to developing countries. Obviously, this resource-intensive trade remedy tool is less useful to these countries than it is to developed countries.[1722]

Importing country undertaking CVDs action	CVDs initiations	CVDs measures
United States	94	57
European Communities	48	23
Canada	23	15
Mexico	2	8
Brazil	3	7
Argentina	3	4
South Africa	13	4
New Zealand	6	4
Peru	4	3
Australia	10	2
Chile	6	2
Costa Rica	1	1
Japan	1	1
Turkey	1	1
Venezuela	2	1

TABLE 4: IMPORTING COUNTRIES THAT HAVE IMPOSED CVDS MEASURES OVER THE PERIOD 1 JANUARY 1995 – 30 JUNE 2009[1723,1724]

As this Table shows, the large majority of all CVDs actions are taken by three developed countries, with the US taking the lion's share, followed by the EC and Canada. Several other WTO Members, including some developing countries, have likewise imposed CVDs, but not to a significant extent. Take into account that almost all CVDs measures by Brazil (5 out of 7) and Mexico (7 out of 8) were already imposed in 1995. In the first half of 2009, China (against US imports) as well as India (against Chinese imports) initiated their first CVDs

[1719] Australia, South-Africa, and India have already launched at least one CVDs investigation against imports from China.
[1720] India's imports have also been subject to CVDs measures by countries like Canada, South Africa, and Brazil.
[1721] More countries have already initiated CVDs.
[1722] In case of tariff overhang, countries could respond by raising their applied level of tariffs up to their bound level but this should be done on an MFN basis.
[1723] WTO Secretariat statistics based on notifications by WTO Members. Available at:
http://www.wto.org/english/tratop_e/scm_e/cvd_init_rep_member_e.pdf.
http://www.wto.org/english/tratop_e/scm_e/cvd_meas_rep_member_e.pdf.
[1724] For the explanation why the level of CVDs measures imposed by Brazil and Mexico is higher than the initiated number, see above n 1716.

investigation. Overall, the 2009 World Trade Report calculated that developed countries account for 86% of all CVDs measures.[1725]

6.1.4. Conclusion

Table 5 summarizes the policy space presently given to developing countries to subsidize non-agricultural products.

<table>
<tr><th></th><th>Annex VII countries</th><th>Small trading countries (certain programmes)</th><th>Other developing countries</th></tr>
<tr><td>Export subsidies</td><td>- prohibited only if export competitiveness: phase-out of 8 years
- actionable under Articles 5 and 6
- countervailable if above de minimis</td><td>- prohibited only if export competitiveness: phase-out of 2 years
- actionable under Articles 5 and 6
- countervailable if above de minimis</td><td>- prohibited
- actionable under Articles 5 and 6
- countervailable if above de minimis</td></tr>
<tr><td>Local content subsidies</td><td colspan="3">- prohibited
- actionable under Articles 5 and 6
- countervailable if above de minimis</td></tr>
<tr><td>All other subsidies[1726]</td><td colspan="3">- actionable if a) injury to the domestic industry
b) nullification or impairment GATT obligations
[c) serious prejudice under Article 6.3 if one of the four cases of subsidization under Article 6.1][1727]
unless privatization programme
- countervailable if above de minimis</td></tr>
</table>

TABLE 5: S&D TREATMENT FOR DEVELOPING COUNTRIES UNDER THE SCM AGREEMENT

The discussion in this section has illustrated that this S&D treatment does certainly not give them *carte blanche* but likewise that some of its basic aspects are still surprisingly unclear. Two main features – raising two unanswered questions – should be recalled in particular. First, only a limited number of developing countries presently benefits from an exception on the prohibition on export subsidies. Yet, it seems that actionable subsidy claims against their export subsidies can be based on the broad 'serious prejudice'-category (Article 5 and 6 of the SCM Agreement). Second, developing countries benefit from substantive S&D treatment on domestic subsidies (except for local content subsidies). In the usual case, their domestic subsidies are only challengeable if they cause injury to the importing country's domestic industry or nullify/impair GATT commitments that would normally benefit exports to the subsidizing country. Yet, an unsettled question is whether, in case subsidies fall under one of the types of Article 6.1, they would be vulnerable to a 'serious prejudice'-claim (Article 6.3 of

[1725] World Trade Report 2009, above n 1714, at 140.
[1726] An exception has to be made for China for which 'other subsidies' are simply actionable under Articles 5 and 6 of the SCM Agreement.
[1727] This is put between brackets because it is not clear whether this option is still available since the expiration of Article 6.1 of the SCM Agreement. Arguably, this claim could no longer be formulated.

the SCM Agreement). If so, developing countries' subsidies exceeding 5 per cent of the value of the product or covering operating losses would be challengeable similar as in case of subsidization by developed countries. On the other hand, in the somewhat more likely case that the expiration of Article 6.1 of the SCM Agreement would have foreclosed such 'serious prejudice'-claims, adverse effects occurring in third countries or in the subsidizing country in absence of nullification or impairment could not be challenged. Lastly, it should be kept in mind that CVDs against all types of subsidies by developing countries are allowed, subject merely to a somewhat higher *de minimis* threshold.

6.2. RATIONE MATERIAE: AGREEMENT ON AGRICULTURE

Trade liberalization of agricultural products has always deserved a separate treatment when discussing international disciplines. During the GATT area, the differential treatment was apparent in the text of the GATT 1947 and in the Subsidies Code.[1728] When disciplining export subsidies as part of the 1954-1955 Review Session, the GATT reserved a separate position for subsidies on the export of primary goods. They were permitted as long as they did not lead to 'more than an equitable share of world export trade' for the subsidizing country.[1729] The Subsidies Code did not fundamentally alter this more flexible stance. During the Uruguay Round, the Cairns group pushed for trade liberalization in this field and this call was supported by the US. Combined with the rise of agricultural disputes and the heavy financial burden of subsidization in the EC and US, this formed the impetus for concluding an Agreement on Agriculture aiming to achieve greater liberalization of trade in agriculture.[1730] The preamble of the Agreement on Agriculture likewise expresses the concerns of Members opposing to further trade liberalization. Indeed, it refers to non-trade such as food security, environmental protection, and the negative effects on LDCs and net food-importing developing countries of further liberalization. Overall, the Agreement on Agriculture reflects recognition 'that the long-term objective of substantial progressive

[1728] See above Part II, Chapter 1.
[1729] This exception was considered the 'Achilles heel' of the GATT to constrain subsidy programmes. A difficult legal question was the correct interpretation of 'equitable share'. Another difficulty was the proof of the causal relationship between the grant of a subsidy and the acquisition of more than an equitable share of world trade. The Subsidies Code did not overcome these legal problems (see Article 10.2 of the Subsidies Code; see also above n 566). See T. Josling and S. Tangermann, 'Production and Export Subsidies in Agriculture: Lessons from GATT and WTO Disputes Involving the US and the EC', in E-U. Petersmann and M.A. Pollack (eds), *Transatlantic Economic Disputes – the EU, the US, and the WTO* (Oxford: Oxford University Press, 2003), 207-232, at 215; J. McMahon, *The WTO Agreement on Agriculture – a Commentary* (Oxford: Oxford University Press, 2006), 333 pp., at 90.
[1730] For the coverage of the Agreement on Agriculture, see the definition of agricultural products in Annex 1 Agreement on Agriculture.

reductions in support and protection resulting in fundamental reform is an ongoing process'.[1731]

The conclusion of the Agreement on Agriculture was therefore considered a starting point for liberalizing trade in agriculture. The framework for further liberalization consists of three main pillars. The first pillar on market access requires WTO Members to convert nontariff barriers[1732] into ordinary customs duties (tariffication) and to subsequently bind and reduce the latter (progressive liberalization).[1733] The other two pillars deal with subsidies and will be introduced below. The second pillar consists of commitments and general disciplines on domestic support,[1734] and the third pillar covers the same with regard to export subsidies.[1735] In this discussion, the interplay between this set of disciplines under the Agreement on Agriculture and the SCM Agreement also deserves special attention. The expiration of the peace clause partly removed the distinction between disciplines on agricultural and industrial subsidies.

6.2.1. Export competition

6.2.1.1. Order of analysis

A preliminary question is under which multilateral trade agreement agricultural export subsidies have to be scrutinized and, if more than one agreement is applicable, under which it has to be analyzed first.

Two provisions are relevant in this respect. First, the Agreement on Agriculture applies to agricultural products as defined in Annex 1[1736] and, pursuant to Article 21.1, 'the provisions of GATT 1994 and of other Multilateral Trade Agreements in Annex 1A to the WTO Agreement *shall apply subject to the provisions of this Agreement*'.[1737] This provision thus expressly provides for the application of the SCM Agreement and the GATT to agricultural products[1738] but, at the same time, implies according to the Appellate Body that these other agreements apply 'except to the extent that the Agreement on Agriculture contains specific

[1731] Article 20 of the Agreement on Agriculture.
[1732] See footnote 1 of the Agreement on Agriculture for a non-exhaustive list of such measures.
[1733] See Part III of the Agreement on Agriculture. See exceptions provided by Article 5 of the Agreement on Agriculture and Annex V. Developed countries committed themselves in the Uruguay Round to an average reduction of 36 per cent over 6 years, whereas developing countries had to reduce their tariffs by 24 per cent over 10 years. LDCs were only required to tariffy and bind their tariffs but did not have to make any reduction commitment. See McMahon, above n 1729, at 30.
[1734] Articles 3.1 and 3.2 of the Agreement on Agriculture and Part IV of the Agreement on Agriculture.
[1735] Articles 3.1 and 3.3 of the Agreement on Agriculture and Part V of the Agreement on Agriculture.
[1736] Article 2 of the Agreement on Agriculture.
[1737] Emphasis added.
[1738] Panel Report, *US – Upland Cotton*, para 7.257.

provisions dealing specifically with the same matter'.[1739] Second, Article 3.1 of the SCM Agreement prohibits export subsidies and local content subsidies 'except as provided in the Agreement on Agriculture', which indicates according to the Appellate Body that the WTO-consistency of agricultural export subsidies should be scrutinized, in the first place, under the Agreement on Agriculture.[1740]

Referring to both provisions, panels have analyzed agricultural export subsidy claims first under the Agreement on Agriculture.[1741] Nonetheless, as the Appellate Body highlighted, the SCM Agreement already offers guidance in interpreting the relevant provisions of the Agreement on Agriculture.[1742] Once the analysis under the Agreement on Agriculture is conducted, the question on the applicability of the SCM Agreement emerges. The scope for such additional scrutiny under the SCM Agreement is addressed in the final section (see below Section 6.2.3.1).

6.2.1.2. Disciplines on agricultural export subsidies

'The fundamental general provision of the Agreement on Agriculture concerning export subsidies'[1743] is Article 8. This stipulates that '(e)ach Member undertakes not to provide export subsidies otherwise than in conformity with this Agreement and with the commitments as specified in that Member's Schedule'.[1744] Contrary to the SCM Agreement, agricultural export subsidies are thus *not* principally prohibited under the Agreement on Agriculture. In disciplining agricultural export subsidies, the Agreement on Agriculture draws a distinction between listed types of export subsidies, which are pursuant to the chapeau of Article 9.1 'subject to reduction commitments', and other types of export subsidies, which are subject to

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[1739] Appellate Body Report, *US – Upland Cotton*, para 532; Appellate Body Report, *EC – Bananas III*, para 155; Appellate Body Report, *Chile – Price Band System*, para 186.

[1740] Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para 123.

[1741] Panel Report, *Canada – Dairy*, paras 7.18-7.23; Panel Report, *EC – Export Subsidies on Sugar*, para 7.101; Panel Report, *US – Upland Cotton*, above n 1738, paras 7.251-7.262. But as the Panel in *US – Upland Cotton* (para 7.263) correctly observed, this order of analysis was not followed by the Panel and Appellate Body in the *US – FSC* dispute because that dispute did not primarily concern agricultural products.

[1742] In the words of the Appellate Body: '(a)lthough an export subsidy granted to agricultural products must be examined, in the first place, under the *Agreement on Agriculture*, we find it appropriate, as has the Appellate Body in previous disputes, to rely on the *SCM Agreement* for guidance in interpreting provisions of the *Agreement on Agriculture*'. Appellate Body Report, *US – Upland Cotton*, para 571. See also Panel Report, *Canada – Dairy*, para 7.23. The Panel cited the Appellate Body's statement in *Brazil – Desiccated Coconut*: '(W)ith respect to subsidies on agricultural products (…) (t)he *Agreement on Agriculture* and the *SCM Agreement* reflect the latest statement of WTO Members as to their rights and obligations concerning agricultural subsidies'.

[1743] Panel Report, *Canada – Dairy*, para 7.27.

[1744] The Appellate Body emphasized that compliance with both the Agreement on Agriculture and the commitments as specified in a Member's schedule is prescribed under Article 8 of the Agreement on Agriculture. This is only possible if those commitments are in conformity with the Agreement on Agriculture. Appellate Body Report, *EC – Export Subsidies on Sugar*, paras 216 and 220.

the anti-circumvention requirement of Article 10.1. Next, Article 10.1 also makes 'non-commercial transactions' (e.g., food aid support) subject to the anti-circumvention provision.

The concept of 'export subsidies' under the Agreement on Agriculture refers, pursuant to Article 1(e), to 'subsidies contingent upon export performance, including the export subsidies listed in Article 9 (…)'.
The term 'export contingency' is thus defined similar as under Article 3.1(a) of the SCM Agreement. This means that the case law developed on this concept under the SCM Agreement can be transposed to the Agreement on Agriculture.[1745]
The 'subsidy'-concept is, however, not further defined under the Agreement on Agriculture. In contrast, as covered above, Article 1.1 of the SCM Agreement defines a subsidy on the basis of two constitutive elements: (a) a financial contribution by a government *or* any form of income or price support in the sense of Article XVI of the GATT (b) that confers a benefit. Because this is the only provision in the WTO Agreements defining subsidies, the Panel in *US – FSC* held that it is 'highly relevant context for the interpretation of the word "subsidy" within the meaning of the Agreement on Agriculture'.[1746] On the other hand, the same Panel did 'not say that the definition in the SCM Agreement (…) is directly applicable to the Agreement on Agriculture' given that Article 1 of the SCM Agreement explicitly refers to 'for the purpose of this Agreement'. Hence, it did not *a priori* preclude that a subsidy is defined differently under the Agreement on Agriculture.[1747] But generally speaking and 'subject to any provision of the Agreement on Agriculture under which the contrary is to be inferred',[1748] a subsidy within the meaning of the SCM Agreement is considered a subsidy within the meaning of the Agreement on Agriculture.[1749] Likewise finding inspiration in Article 1.1(a)(1) of the SCM Agreement, the Appellate Body in *Canada – Dairy* explained that a subsidy in the Agreement on Agriculture 'involves a transfer of economic resources from the grantor to the recipient for less than full consideration'.[1750] Subsequent Appellate Body reports have relied on these 'definitional elements of a subsidy in the context of the

[1745] Appellate Body Report, *US – FSC*, para 7.150; Appellate Body, *US – Upland Cotton*, paras 571-584.
[1746] Panel Report, *US – FSC*, para 7.150
[1747] Panel Report, *US – FSC*, para 7.150 (see also footnote 702). Reviewing the listed types of export subsidies, Desta holds that these would normally also be covered under the broad definition of Article 1 of the SCM Agreement. Desta, above n 632, at 224.
[1748] The Panel referred, for instance, to the list of subsidies in Article 9.1 of the Agreement on Agriculture.
[1749] Panel Report, *US – FSC*, para 7.150.
[1750] Appellate Body Report, *Canada – Dairy*, para 87. The Appellate Body thus seems somewhat more restraint to take the subsidy definition of the SCM Agreement into consideration as context for interpreting provisions which do not explicitly use the wording 'subsidy'. For example, in deciding on whether 'payments' in Article 9(c) include payments in kind, the Appellate Body only referred to contextual support in the Agreement on Agriculture and not to Article 1 of the SCM Agreement. Appellate Body, *Canada – Dairy*, paras 107-112.

Agreement on Agriculture'.[1751] The Appellate Body thus reformulated the benefit and financial contribution elements of Article 1 of the SCM Agreement.[1752] Observe that the Appellate Body's definition refers to a 'grantor' in general and not to 'the government' in particular. This suggests that the nexus to the government could be looser under the Agreement on Agriculture than under Article 1.1(a)(1) of the SCM Agreement.[1753] This will be illustrated in the following discussion on the treatment of those export subsidies listed in Article 9.1. Next, the scope and disciplines on non-listed types of export subsidies will be clarified.

6.2.1.2.1. Listed types of export subsidies

6.2.1.2.1.1. Scope

Article 9.1 lists six types agricultural export subsidies, which can be summarized as follows: (a) direct subsidies to agricultural producers[1754] contingent upon export performance; (b) the sale or disposal for export of non-commercial stocks of agricultural products at a lower price than for buyers in the domestic market; (c) payments on the export of an agricultural product financed by virtue of governmental action; (d) subsidies to reduce the costs of marketing exports of agricultural products; (e) the more favourable provision of internal transport and freight charges on export shipments than on domestic shipments; and (f) subsidies on agricultural products contingent on their incorporation in exported products.

Before analyzing those items further clarified in the case law, note that the Appellate Body has confirmed that that this list of practices 'by definition, involve export subsidies' under the Agreement on Agriculture.[1755] This reasoning generates two implications. First, somewhat parallel to the Illustrative List under the SCM Agreement, the Appellate Body correctly reads the listed types of export subsidies in Article 9.1 as *per se* export subsidies in the meaning of

[1751] Appellate Body Report, *US – Upland Cotton*, para 615, footnote 913. The Appellate Body in *US – FSC* applied this definition but in its examination largely referred to its analysis conducted under Article 1 of the SCM Agreement (Appellate Body Report, *US – FSC*, paras 136-139). The Appellate Body in *US – Countervailing Duty Investigation on DRAMS* (footnote 212) also referred to this description in its analysis under the SCM Agreement.
[1752] The phrase 'economic resources' might also encompass income or price support in the meaning of Article XVI of the GATT.
[1753] Appellate Body, *Canada – Dairy*, para 87. Noticing that the Panel only referred to the 'benefit' element under Article 1 of the SCM Agreement, the Appellate Body remarked that 'the Panel failed entirely to make any mention of the other integral aspect of a 'subsidy' under Article 1.1 of the *SCM Agreement*, namely the need for a 'financial contribution'' (para 90).
[1754] Or to a firm or industry of an agricultural product; or a cooperative or other association of such producers; or to a marketing board.
[1755] Appellate Body Report, *EC – Export Subsidies on Sugar*, para 269.

Article 1(e) of the Agreement on Agriculture.[1756] Hence, complainants can directly jump to one of these items listed in Article 9, without the need for a separate demonstration of an 'export subsidy' in the meaning of Article 1(e) of the Agreement on Agriculture. Second, in the words of the Panel in *US – FSC*, 'a measure which is listed as an export subsidy in Article 9.1 of the Agreement on Agriculture is an export subsidy for the purposes of the Agreement on Agriculture independently of the definition of subsidy in the SCM Agreement'.[1757] Thus, a measure falling within the description of one of the items of Article 9 is deemed to be an export subsidy, regardless whether it conforms to the definitional elements set forth in either Article 1 *juncto* 3 or the Illustrative List of the SCM Agreement. To be sure, this does not mean that these SCM Agreement provisions are not relied upon as contextual support for interpreting Article 9.1 of the Agreement on Agriculture.

6.2.1.2.1.1.1. Direct subsidies to agricultural producers contingent upon export performance

Export subsidies under Article 9.1(a) exist if four conditions are present: (i) the provision by governments or their agencies of (ii) direct subsidies, including payments-in-kind, (ii) to a firm, to an industry, to producers of an agricultural product, to a cooperative or other association of such producers, or to a marketing board, (iv) contingent on export performance.[1758]

Regarding the first condition, the Appellate Body in *Canada – Dairy* found that the essence of *'governments'* is that they 'enjoy the effective power to "regulate", "control" or "supervise" individuals, or otherwise "restrain" their conduct, through the exercise of lawful authority'.[1759] Consequently, a *government agency* was defined as an entity which exercises powers vested in it by a government for the purpose of performing such functions of a governmental character.[1760] Hence, two constitutive elements should be present: power is delegated (source) enabling a function of a governmental character to be exercised. Applied to the facts of the case, the Canadian milk marketing boards were considered 'government agencies' because they acted on the basis of delegated powers vested in them by federal and provincial

[1756] 'Article 9.1 sets forth a list of practices that, by definition, involve export subsidies. In other words, a measure falling within Article 9.1 is deemed to be an export subsidy within the meaning of Article 1(e) of the *Agreement on Agriculture*'. Appellate Body Report, *EC – Export Subsidies on Sugar*, para 269.
[1757] Panel Report, *US – FSC*, footnote 702. This view was implicitly endorsed by the Appellate Body in *Canada – Dairy (Article 21.5 – New Zealand and US II)* in its interpretation of the scope of Article 9(c) of the Agreement on Agriculture (see below).
[1758] See also Panel Report, *Canada – Dairy*, para 7.38.
[1759] Appellate Body Report, *Canada – Dairy*, para 97.
[1760] Appellate Body Report, *Canada – Dairy*, para 97.

governments and this enabled them to regulate a particular sector of the economy (i.e., the dairy sector).[1761]

Next, such governments or government agencies should provide *'subsidies, including payments-in-kind'*. Here, the Appellate Body developed the 'subsidy'-definition as 'a transfer of economic resources from the grantor to the recipient for less than full consideration'.[1762] The Appellate Body rejected the Panel's view that all payments-in-kind *ipso facto* qualify under this definition.[1763] Regarding such 'a transfer of economic resources, in a form other than money',[1764] it should likewise be demonstrated that it is provided at beneficial terms to the recipient.[1765]

The potential *recipient* of this subsidy is defined in a broad way under Article 9.1(a). It could be made not only to individual producers but also to a cooperative of such producers, or to a marketing board. Finally, regarding the *'export contingency'* condition, the discussion already mentioned that this is applied similar to the case law developed under the SCM Agreement.[1766]

<u>6.2.1.2.1.1.2. Payments on the export of an agricultural product financed by virtue of governmental action</u>

An export subsidy in the meaning of Article 9.1(c) is present if two conditions are fulfilled: (i) 'payments on the export of an agricultural product' (ii) that are 'financed by virtue of governmental action'.[1767]

To grasp the case law's wide interpretation of this form of export subsidies, some essential facts of the *Canada – Dairy* and *EC – Export Subsidies on Sugar* disputes have to be introduced.[1768] First, in order to comply with the DSB recommendations of the original procedures in *Canada – Dairy*, Canada had introduced a new category of milk for export processing (i.e., Commercial Export Milk) which was exempted from price regulation applicable to other types of milk. At the first and second compliance level, complainants (US and New Zealand) advocated that the supply of CEM by Canadian milk producers to dairy

[1761] This conclusion held even given that they enjoyed a high degree of discretion in the exercise of their power and exercised this power in the interest of particular traders, namely producers. Appellate Body Report, *Canada – Dairy*, paras 97-102.
[1762] Appellate Body Report, *Canada – Dairy*, para 87.
[1763] Appellate Body Report, *Canada – Dairy*, para 87.
[1764] Appellate Body Report, *Canada – Dairy*, paras 87, 107.
[1765] The Panel had concluded that all payments-in-kind are *by definition* at beneficial terms and thus 'direct subsidies'. Appellate Body Report, *Canada – Dairy*, paras 84-92.
[1766] Appellate Body Report, *US – FSC*, para 7.150; Appellate Body, *US – Upland Cotton*, paras 571-584. See above Part II, Chapter 4, Section 4.1.
[1767] See also Panel Report, *Canada – Dairy*, para 7.89.
[1768] To be sure, only those aspects relevant for our discussion below are spelled out.

processors (used as input for exports of processed dairy products) qualified as an export subsidy under Article 9.1(c). In *EC – Export Subsidies on Sugar*, the EC had established two categories of production quotas, one for 'A sugar' and the other for 'B sugar', which constituted the maximum quantities eligible for domestic price support and direct export subsidies. Sugar produced in excess of A and B quota levels, labeled 'C sugar', was not eligible for domestic price support or direct export subsidies and had to be exported. Parties disagreed on whether exports of C sugar were nonetheless benefiting from an export subsidy in the meaning of Article 9.1(c).[1769] Observe at this point that in both cases the alleged payments were not made by the respective governments but by independent producers.

Regarding the first condition, a *'payment'* is interpreted in a broad sense as a transfer of economic resources, which could be either in form of money or in any other form such as the provision of goods/services or revenue foregone.[1770] As the Appellate Body in *Canada – Dairy (Article 21.5 – New Zealand and US)* stressed, such transfers qualify as 'payments' only if they are made at beneficial terms. In this case, the Appellate Body had to decide whether the sale of Commercial Export Milk (CEM) by producers, which were *independent* economic operators, involved a 'payment' to processors for exports. The provision of milk is a payment-in-kind that would be covered if sold at beneficial terms. Concerning the appropriate benchmark for this benefit analysis, the Appellate Body rejected the domestic market price for milk because this price was an administered price fixed by the Canadian government.[1771] The world market price was likewise refuted for the obvious reason that it was possible that the reason why CEM could be sold at world market prices was 'precisely because sales of CEM involve subsidies that make it competitive'.[1772] Because the benchmark should be 'objective and based on the value of the milk to the producer', the Appellate Body turned to the average total *cost of production*.[1773] The Appellate Body deemed this benchmark appropriate because it 'focuses upon the motivations of the independent economic operator who is making the alleged "payments" – here the producer – and not upon any government intervention in the marketplace'.[1774] If producers were selling milk at below production costs, they were making a payment to processors. In this respect, the Appellate Body further specified that this should be calculated on the basis of the

[1769] There was no disagreement that A and B sugar was benefiting from export subsidies.
[1770] Appellate Body Report, *Canada – Dairy*, paras 107-114.
[1771] Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para 81.
[1772] Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, paras 83-84.
[1773] Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para 86.
[1774] Interestingly, the cost-to-government standard in items (j) and (k) of the Illustrative List was relied upon as useful context supporting the cost of production as benchmark. Appellate Body Report, *Canada - Dairy (Article 21.5 – New Zealand and US)*, paras 92-93.

producers' *average* total costs of production and not on their marginal costs.[1775] Furthermore, this is an industry-wide average production cost, rather than an individual producer's cost of production.[1776] Lastly, it includes selling costs (e.g., transport, marketing, and administrative costs) and non-monetary costs (e.g., the costs of family labor/management and of owner's equity) since the latter involve an economic opportunity cost.[1777] In sum, a payment is made at beneficial terms if it does not cover the average industry-wide total cost of production. Applied to the facts of the case in the second compliance procedure, the Appellate Body found that the supply of CEM by producers to processors involved 'a payment' because CEM was sold below the average total cost of production and thus transferred economic resources from producers to processors.

Turning to *EC – Export Subsidies on Sugar*, two types of alleged 'payments' to sugar C producers were scrutinized. The Panel relied upon the average cost of production as benchmark spelled out in the *Canada – Dairy* findings. First, the Panel agreed that the sale of C *beet* (i.e., the main input for C sugar) to C sugar producers below the total average cost of production of C beet was indeed a 'payment' to C sugar producers.[1778] Second, the Panel and Appellate Body also agreed that there was a 'payment' in the form of cross-subsidization resulting from the profits made on sales of A and B *sugar* used to cover the fixed costs of the production/export of C sugar. The fact that this transfer was made by the sugar producer to *itself* was no obstacle because a 'payment' does not necessarily require the presence of two distinct legal entities (i.e., grantor and recipient).[1779]

To qualify as an export subsidy, such a payment has to be *'on the export'*. This aspect was not much disputed in the compliance procedures of *Canada – Dairy*. CEM was defined as milk that must be exported, implying that any payment in relation thereto was on the

[1775] The average total production cost includes all *fixed* and variable costs, divided by the total number of units produced. The marginal production cost refers to the additional cost of producing one extra unit and thus excludes fixed costs. The Appellate Body recognized that 'a producer may very well decide to sell goods or services if the sales price covers its marginal costs', but 'the producer will make losses on such sales unless all of the remaining costs associated with making these sales, essentially the fixed costs, are financed through some other source, such as through highly profitable sales of the product in another market'. In the long-term, the producers should be able to also recoup fixed costs to avoid making losses. Moreover, the Appellate Body assumed that '(i)n the ordinary course of business, an economic operator chooses to invest, produce and sell, not only to recover the total cost of production, but also in the hope of making profits'. Therefore, the higher average total cost of production was considered appropriate as benchmark. Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, paras 94-95.

[1776] Because '(t)he question is not whether one or more individual milk producers, efficient or not, are selling CEM at a price above or below their individual costs of production. The issue is whether Canada, on a national basis, has respected its (…) commitment levels'. Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, paras 91-98.

[1777] Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, paras 99-116.

[1778] Panel Report, *EC – Export Subsidies on Sugar*, paras 7.254-7.270

[1779] Panel Report, *EC – Export Subsidies on Sugar*, paras 7.294-7.314; Appellate Body Report, *EC – Export Subsidies on Sugar*, paras 257-271.

export.[1780] Likewise, regarding cross-subsidization of C *sugar* by the profits made on sales of A/B sugar, the Panel and Appellate Body in *EC – Export Subsidies on Sugar* concluded that this payment was made 'on the export' because C sugar had to be exported.[1781] The EC's concern that this interpretation blurred the distinction between disciplines on domestic support and those on export subsidies was not accepted.[1782] In addition, the Panel dwelled upon the interpretation of 'on the export' for its finding that the sale of C *beet* to C sugar producers was also made 'on the export'. In this respect, the Panel held that such a payment should not be 'contingent' on exports[1783] but should merely be 'in connection' with exports.[1784] The Panel reasoned that:

> When identifying whether a payment is *on the export* as defined under Article 9.1(c) of the *Agreement on Agriculture*, once a payment is identified, the focus is on whether *this payment* is made *on the export*, and not on whether the source of the payment is dependent or contingent on export production.[1785]

Because this aspect of the panel report was not appealed, the Appellate Body did explicitly refrain from taking position on whether it would agree with this wide interpretation.[1786]

Finally, to be labeled an export subsidy under Article 9.1(c), such payments on the export should be *'financed by virtue of government action'*. Payments made or funded by private parties could, according to the Appellate Body, fall within its scope as long as the government plays a 'sufficiently important part' in this process. A tight nexus has to exist between the government action and the financing of payments.[1787] This nexus is not present if a regulatory framework would be set up 'merely *enabling* a third person to make and finance 'payments''.[1788] On the other hand, the required nexus is not so demanding that it only

[1780] Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para 9.78; Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, para 5.23 (this element was not appealed).
[1781] The fact that they did not have to produce C sugar did not undermine this conclusion because C sugar '*once produced*, must be exported'. Appellate Body Report, *EC – Export Subsidies on Sugar*, paras 275-276.
[1782] The Appellate Body recalled that 'if domestic support could be used, without limit, to provide support for exports, it would undermine the benefits intended to accrue through a WTO Member's export subsidy commitments'. Appellate Body Report, *EC – Export Subsidies on Sugar*, para 280; Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para 91.
[1783] This is the standard under Article 3.1 of the SCM Agreement.
[1784] Panel Report, *EC – Export Subsidies on Sugar*, para 2.275.
[1785] Panel Report, *EC – Export Subsidies on Sugar*, para 2.273.
[1786] In doing so, the Appellate Body seemed to hint that it would not easily agree with this reasoning. Appellate Body Report, *EC – Export Subsidies on Sugar*, para 274.
[1787] Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, paras 128 and 133. See also Appellate Body Report, *EC – Export Subsidies on Sugar*, paras 237-239; Panel Report, *EC - Export Subsidies on Sugar*, para 7.289.
[1788] Appellate Body Report, *EC – Export Subsidies on Sugar*, para 237; Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para 115.

captures situations where the government mandates or directs that payments be made.[1789] The Appellate Body even explicitly contrasted the broad scope of this 'unusual form of subsidy'[1790] with Article 1.1.(a)(iv) of the SCM Agreement and some items of the Illustrative List. Under the SCM Agreement, 'some kind of government mandate, direction, or control is an element of a subsidy provided through a third party'.[1791] In *Canada – Dairy (Article 21.5 – New Zealand and US II)*, the Appellate Body found that producers' payments (i.e., selling CEM at beneficial terms) were made by virtue of government action because the government played a sufficient important part in this process. This conclusion was reached even though the Appellate Body acknowledged that producers were 'entirely free to produce milk for sale as CEM, and it is for them to agree the price, volume, and timing of the sale with the buyers'.[1792] Producers were able to sell CEM below production cost as a result of their participation in the *domestic* market, which was virtually controlled by the government through price fixing of domestic milk (rendering it highly remunerative), quotas on supply, and tariffs. In this way, the regulation of the domestic market had become an instrument for granting export subsidies.[1793] Although the government did not direct or mandate producers to sell at beneficial terms, producers' payments qualified as 'export subsidies' in the meaning of Article 9.1(c) of the Agreement on Agriculture. In *EC – Export Subsidies on Sugar*, the Panel and Appellate Body also found sufficient elements for a 'tight nexus' between the EC's governmental action and the financing of payments to producers of C sugar.[1794]

In conclusion, the case law has developed an expansive interpretation of the type of export subsidies listed in Article 9.3(c) of the Agreement on Agriculture. Its scope is clearly broader than export subsidies defined under Article 1 *juncto* 3 of the SCM Agreement.[1795] The concept of 'payment' seems to be interpreted in a way that it *de facto* covers both the 'financial contribution' and 'benefit' elements of the subsidy definition in Article 1 of the SCM Agreement, with the particularity that both aspects could also focus on the same private person.[1796,1797] This particularity is linked to the main difference between both sets of

[1789] Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, paras 128 and 133; Appellate Body Report, *EC – Export Subsidies on Sugar*, para 235.
[1790] Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, para 87.
[1791] Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, footnote 113. The Appellate Body also opined that 'Article 9.1(c) (…) contemplates that 'payments' may be made and funded by private parties, without the type of governmental involvement ordinarily associated with a subsidy' (para 87).
[1792] The only obligations imposed upon producers were to not divert CEM to the domestic market and to pre-commit to sell CEM. Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, para 88.
[1793] Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, paras 122-154.
[1794] See Appellate Body Report, *EC – Export Subsidies on Sugar*, paras 237-239.
[1795] With the important nuancing that the subsidy element might be covered under 'income or price support' (Article 1.1(a)(2) of the SCM Agreement).
[1796] Importantly, it does not cover the element 'by the government' of the subsidy definition (see below).

definitions. Under Article 1 of the SCM Agreement, the financial contribution is made, or at least mandated/directed, by the government and the benefit analysis turns to recipient. Under Article 9.1(c) of the Agreement on Agriculture, on the other hand, the payment should merely have a sufficient tight nexus to the government. Hence, the payment could be made by a private person (to itself) even if it is not mandated/directed by the government. In case domestic prices are distorted (e.g., administered prices) – which is not exceptional in the context of agriculture – the (full) cost of production is considered appropriate as benchmark to conduct the benefit analysis. Finally, the Panel in *EC – Export Subsidies on Sugar* has permitted a looser link to exports under Article 9.1(c) of the Agreement on Agriculture. Payments should not be 'conditional' upon exports but only 'in connection with exports', though the Appellate Body has not yet approved this interpretation.[1798]

6.2.1.2.1.1.3. Subsidies to reduce the costs of marketing exports of agricultural products

The Appellate Body in *US – FSC* has clarified the scope of 'subsidies to reduce *the costs of marketing exports* of agricultural products' (Article 9.1(d) of the Agreement on Agriculture). The text itself stipulates that these costs include handling, upgrading, and other processing costs, as well as the cost of international transport and freight. On the other hand, widely available export promotion and advisory services are explicitly excluded from its scope. Examining this list, the Appellate Body considered that marketing costs are confined to 'types of costs that are incurred *as part of* and *during* the process of selling a product'.[1799] Consequently, such costs do not include general business costs, such as administrative overhead and debt financing costs, or income tax exemptions. Therefore, the FSC tax exemption challenged in *US – FSC* did not qualify as an export subsidy in the meaning of Article 9.1(d) of the Agreement on Agriculture.[1800] The scope of this listed type of export subsidy is of particular importance to developing countries. As explained in the following section, these countries benefit from S&D treatment on subsidies to reduce the costs of marketing exports.

[1797] To be precise, a financial contribution could also be made by the *government* to itself (i.e., to a government-owned enterprise) under article 1 of the SCM Agreement (see above n 673).
[1798] Somehow, such a more flexible approach regarding the link to exportation seems to be again a consequence of the looser nexus to the government. Under the SCM Agreement, it can be scrutinized whether exportation was a condition to receive the financial contribution by the government. Under Article 9.1(c), however, the payment could be made by private parties, which will *strictly speaking* not make such a payment at beneficial terms *conditional* upon exportation. The export stimulating effect is rather derived from the structure of the entire governmental framework.
[1799] Appellate Body Report, *US – FSC*, paras 129-131 (emphasis in the original).
[1800] Appellate Body Report, *US – FSC*, paras 131-132. The Panel had reached the opposite conclusion. See Panel Report, *US – FSC*, para 7.159.

6.2.1.2.1.2. Disciplines

The list in Article 9.1 of the Agreement on Agriculture lays, by virtue of Article 3.3 of the Agreement on Agriculture, 'the foundation for the core rules of the Agreement relating to export subsidies'.[1801] Article 3.3 of the Agreement on Agriculture reads:

> Subject to the provisions of paragraphs 2(b) and 4 of Article 9, a Member shall not provide export subsidies listed in paragraph 1 of Article 9 in respect of the agricultural products or groups of products *specified* in Section II of Part IV of its Schedule in excess of the budgetary outlay and quantity commitment levels specified therein and shall not provide such subsidies in respect of any agricultural product *not specified* in that Section of its Schedule.[1802]

This provision draws an important distinction between scheduled (i.e., specified) and unscheduled (i.e., unspecified) agricultural products. WTO Members were entitled in the Uruguay Round[1803] to specify in their Schedules agricultural products that were benefiting from listed types of export subsidies during the 1986-1990 base period and these were made subject to reduction commitments. Considering such *scheduled* agricultural products, the listed types of export subsidies are prohibited only to the extent they are in excess of the reduction commitment level of the Member in question. These reduction commitments made during the Uruguay Round were disaggregated at the product level[1804] and expressed in terms of both a budgetary outlay commitment and export quantity commitment.[1805] Developed WTO Members committed themselves to reducing their level of export subsidies by the year 2000 by 36 per cent in value terms and by 21 per cent in volume terms from a 1986–1990 base period.[1806] Developing countries had to reduce their level of support by 24 per cent in value terms and 14 per cent in volume terms over ten years, and LDCs did not have to make any reduction commitment.[1807] But these reduction commitments were only meaningful with

1801 Panel Report, *Canada – Dairy*, para 7.28.
1802 Emphasis added.
1803 Or at the moment of accession if they acceded later.
1804 Twenty-two product groupings were specified: wheat and wheat flour, coarse grains, rice, oilseeds, vegetable oils, oilcakes, sugar, butter and butter oil, skim milk powder, cheese, other milk products, bovine meat, pig meat, poultry meat, sheep meat, live animals, eggs, wine, fruit and vegetables, tobacco, cotton. But reduction commitments could also be specified at a more disaggregate level. See *Note by Chairman of the Market Access Group, Modalities for the Establishment of Specific Binding Commitments under the Reform Program* (MTN.GNG/MA/W/24, 20 December 1993) (Modalities Paper). The tariff lines for the corresponding product or group of products at which reduction commitments have been made can be found in the *Note by the Secretariat, Export Subsidy Commitments* (TN/AG/S/8/Rev.1, 2 February 2005.
1805 The 'budgetary outlay commitment' prescribes the annual maximum level of expenditure for such export subsidies to the product in question. The 'export quantity commitment' prescribes the annual maximum level of the product in question that could benefit from such export subsidies. Exact definitions can be found in Article 9.2(a)(i) of the Agreement on Agriculture. Both budgetary outlay and quantity commitments have to be expressed in a Member's Schedule. See Appellate Body Report, *EC – Export Subsidies on Sugar*, paras 193-200.
1806 During the implementation period, some more flexibility was provided for under Article 9.2(b) of the Agreement on Agriculture.
1807 See Article 9.2(b)(iv) of the Agreement on Agriculture; Modalities Paper, above n 1804, paras 15-16. The reduction commitments are also specified in Members' Schedules and an integral part of

respect to a Member that had effectively scheduled an agricultural product in the first place. Indeed, with regard to *unscheduled* agricultural products, listed types of export subsidies are prohibited *as such*.[1808] Hence, those countries that did not have any of the listed types of export subsidies in place during the Uruguay Round – like all LDCs or countries like India and Korea – were in principle not allowed to introduce them afterwards.[1809] Overall, only 25 WTO Members have specified one or more agricultural products in their Schedule.[1810] Making abstraction from Article 9.4, only these Members have a 'limited authorization'[1811] to provide the listed types of export subsidies for agricultural products insofar the product (or product grouping) in question is included in its Schedule and up to the budgetary outlay and export volume level committed. The final bound export subsidy commitment level[1812] for a scheduled product in a Member's Schedule indicates the maximum level of expenditure for listed subsidies that this Member is entitled to offer annually to the product (or product grouping) in question as well as the maximum volume of that product (or product grouping) that could annually benefit from such subsidies.[1813] In case these levels are reached, 'the

GATT 1994 (Article 3.1 of the Agreement on Agriculture). It should be highlighted that the Modalities Paper is 'not an agreement among WTO Members' (Appellate Body Report, *EC – Export Subsidies on Sugar*, para 199) and 'the Agreement on Agriculture makes no reference to' it (Appellate Body Report, *EC – Bananas III*, para 157). Above, the Modalities Paper also stipulates that it shall 'not be used as a basis for dispute settlement proceedings'.

[1808] Article 3.3 of the Agreement on Agriculture.

[1809] This observation, which makes abstraction of Article 9.4 of the Agreement on Agriculture, is often insufficiently acknowledged. For example, the 2006 World Trade Report generally stated that 'least-developed have been exempted from making any trade liberalization commitments'. World Trade Report 2006, above n 574, at 194.

[1810] Counting the EC as one, which refers to the EC-15. There is still disagreement among WTO Members on how the export subsidy commitments should be rearranged in light of the EC's enlargement to 27 countries (ICTSD, 'Farm Subsidies: Exporters Quiz EU', 14:10 *Bridges Weekly Trade News Digest* (17 March 2010)). These countries are: Australia, Brazil, Bulgaria, Canada, Colombia, Cyprus, Czech Republic, European Communities (EC-15), Hungary, Iceland, Indonesia, Israel, Mexico, New Zealand, Norway, Panama, Poland, Romania, Slovak Republic, South Africa, Switzerland, Lichtenstein, Turkey, US, Uruguay, Venezuela. In particular, these reduction commitments are specified in Section II of Part IV of their Schedule. In addition, some countries (e.g., Costa Rica and Panama) have commitments in Section III of Part IV of their Schedule, which requires them to eliminate or reduce certain incentive schemes applying to non-traditional agricultural products. In total, the 25 WTO Members listed above made 428 export subsidy reduction commitments, of which 421 are product-specific with both budgetary outlay and volume commitments, two apply to 'all agricultural products', and five to 'incorporated products'. As mentioned above, these product-specific commitments are not always made at the product grouping level but have also been made at a more disaggregate level. For example, Bulgaria specified 28 reduction commitments in the product grouping 'fruit and vegetables'. *Note by the Secretariat, Export Subsidy Commitments* (TN/AG/S/8/Rev.1, 2 February 2005)

[1811] Appellate Body Report, *US – FSC*, para 151.

[1812] The implementation period ended in 2000 and 2004 for developed countries and developing countries, respectively.

[1813] Article 9.2(b)(iv) of the Agreement on Agriculture. The final bound levels of commitments (at 5-38) and the corresponding tariff lines at which these commitments have been made (at 39-97) can be found in TN/AG/S/8/Rev.1 (2 February 2005).

limited authorization to provide export subsidies as listed in Article 9.1 is transformed, effectively, into a *prohibition* against the provision of those subsidies'.[1814]

Hence, several scholars in the field and even the 2003 World Trade Report concluded that all countries which did not have export subsidies in place during the base period are prohibited from introducing them afterwards.[1815] Although this general conclusion holds for developed countries, it seems to fail to acknowledge the substantial flexibility[1816] given to developing countries on the basis of Article 9.4. This provision reads:

> During the implementation period, developing country Members shall not be required to undertake *commitments* in respect of the export subsidies listed in subparagraphs (d) and (e) of paragraph 1 above, provided that these are not applied in a manner that would circumvent reduction commitments.[1817]

This provision would normally have lapsed at the end of the 10-years implementation period. However, its application was extended at the Cancun Ministerial Conference (2003) as well as at the Hong Kong Ministerial Conference (2005). The Hong Kong Ministerial Declaration stipulated that '(d)eveloping country Members will continue to benefit from (this provision) for five years after the end-date for elimination of all forms of export subsidies'.[1818] As long as no final date for the elimination of export subsidies is agreed upon, the time horizon of Article 9.4 is open ended.

As a result, 'developing countries' are, subject to the condition of anti-circumvention, not required to undertake 'commitments' in respect of two of the listed types of export subsidies: subsidies to reduce the cost of marketing agricultural exports (item (d)) and the more favourable provision of internal transport and freight charges on export shipments (item (e)). However, the exact scope of this S&D treatment is not well defined. The interpretation

[1814] Appellate Body Report, *US – FSC*, para 152.

[1815] McMahon seems to fail to acknowledge that Article 9.4 has been extended and, on this basis, seems to reach the general conclusion that countries which did not have export subsidies in place during the Uruguay Round are not allowed to introduce them (see McMahon, above n 1729, at 96, footnote 24 and 143). See also, M. G. Desta, 'The Bumpy Ride Towards the Establishment of a Fair and Market-oriented Agricultural Trading System at the WTO: Reflections Following Cancun', 8 *Drake Journal of Agricultural Law* (Fall 2003), 489-537, at 515-516; M. G. Desta, 'Legal Issues in International Agricultural Trade, The Evolution of the WTO Agreement on Agriculture from its Uruguay Origins to its Post-Hong Kong Directions', *FAO Legal Papers Online No. 55* (July 2006), 31 pp., at 19. In one publication Desta considered that Article 9.4 is an exception but only a 'minor' one. See M. G. Desta, 'The Integration of Agriculture in WTO Disciplines', in B. O'Conner (ed), *Agriculture in WTO Law* (London: Cameron May, 2005), 17-41, at 23, footnote 18. See also WTO Secretariat, *World Trade Report 2003* (Geneva: World Trade Organization, 2003), 242 pp., at 181.

[1816] This conclusion holds if a broad reading of Article 9.4 of the Agreement on Agriculture is adopted.

[1817] Article 9.4 of the Agreement on Agriculture (emphasis added). As cited above, Article 3.3 of the Agreement on Agriculture explicitly refers to this exception. Contrary to Article 9.4, Article 9.2(b) has lapsed.

[1818] Hong Kong Ministerial Declaration, para 6. Hence, the latest Revised Draft Modalities for Agriculture would set the end date at 2021 (five years after the end-date for the elimination of export subsidies for developing countries). See Revised Draft Modalities for Agriculture, above n 652, para 164. In contrast, the Cancun Ministerial Declaration only extended its application until the end of phasing out all forms of export subsidies. Cancun Ministerial Declaration, Annex A, para 3.19.

difficulties seem to revolve around the concept of 'commitments' in the opening clause of Article 9.4, which could be read in a twofold way. A narrow and broad reading could be distinguished.

On the one hand, 'commitments' in Article 9.4 could refer to *reduction* commitments upon scheduled agricultural products. Under such a narrow reading, this S&D provision would only be meaningful with respect to developing countries having effectively scheduled an agricultural product in the first place. These developing countries would in principle be allowed to postpone their reduction commitment (24 per cent in value terms and 14 per cent in volume terms) but the value and amount of subsidies exceeding their final bound level should take the form of marketing or transport export subsidies.[1819] In contrast, non-scheduled agricultural products could not benefit from marketing/transport export subsidies. Developing countries that have not scheduled any agricultural product could not introduce marketing/transport export subsidies under this narrow reading. This reading was adopted in a communication by a group of developing countries. They considered that the flexibility of Article 9.4 was not useful to them because they did not have any scheduled agricultural product.[1820] Such a narrow reading might find some contextual support in the 'anti-circumvention' condition spelled out in Article 9.4: marketing/transport export subsidies could not be applied 'in a manner that would circumvent *reduction* commitments'. This condition is per definition only meaningful with respect to agricultural products for which *reduction* commitments have been made. Nonetheless, even with regard to scheduled agricultural products, the substance of this condition is far from evident. Drafters might have had in mind the situation whereby a developing country fulfils its reduction commitment by simply transforming other listed types of export subsidies into marketing/transport export subsidies and thus 'evades, finds a way around' around its reduction commitments.[1821] Yet, operationalizing this anti-circumvention condition along these lines without erasing the

[1819] Because this provision gives flexibility on *reduction* commitments, the amount should not exceed their level of support indicated in their schedule (i.e., pre-commitment level).
[1820] 'With respect to export subsidies, pursuant to Article 9.4 of the Agreement on Agriculture (Agreement on Agriculture), developing countries are not required to undertake *reduction* commitments on some export subsidies. Armenia, Georgia, the Kyrgyz Republic and the Republic of Moldova have already bound their export subsidies at zero, and are deprived from using such flexibility provided to developing countries' (emphasis added). *Communication from Armenia, Georgia, the Kyrgyz Republic and the Republic of Moldova* (TN/AG/GEN/10, 29 June 2005), para 17; see also *Minutes of Meeting, Held in the Centre William Rappard on 21 and 28 July 2005* (TN/C/M/19, 15 September 2005), para 479.
[1821] This is the dictionary meaning of 'circumvention' relied upon by the Appellate Body for the interpretation of Article 10.1 of the Agreement on Agriculture. See Appellate Body Report, *US – FSC*, para 148.

essence of this exception[1822] would bring Article 9.4 close to a standstill provision.[1823] Such an interpretation would overly curtail the scope of Article 9.4 since it would preclude developing countries from introducing new marketing/transport export subsidies for scheduled agricultural products above final bound levels of commitment. This would treat new marketing/transport export subsidies similar to other listed types of subsidies and thus cancel out their S&D status.

Most (developing) countries, however, read Article 9.4 of the Agreement on Agriculture in a broader way. They give meaning to the fact that the wording 'commitments' in the opening phrase of this provision is not qualified by the prefix 'reduction'. Therefore, this term has to refer to commitments not only on scheduled agricultural products (i.e., subject to *reduction* commitment) but also on unscheduled agricultural products (i.e., subject to the commitment not to offer listed export subsidies). This broad reading, which also finds support in the notification requirement procedure,[1824] would entitle all developing countries (except for China)[1825] to offer marketing/transport export subsidies (i) on scheduled products above the final commitment level and on (ii) unscheduled products.[1826] Hence, countries that have not scheduled any agricultural product would still be free to offer these two types of export subsidies.[1827] For example, trade policy reviews and notifications reveal that several of these

[1822] Surely, the anti-circumvention provision could not be interpreted as strictly as under Article 10.1 of the Agreement on Agriculture because this would erase the essence of the exception itself. As elaborated below, circumvention exists under Article 10.1 if non-listed types of export subsidies are offered above reduction commitment levels. But Article 9.4 precisely entitles developing countries to make no commitments on marketing/transport export subsidies during the implementation period.

[1823] Marketing/transport export subsidies in place during the Uruguay Round could be upheld even if the total level of listed export subsidies is above the reduction commitment. In contrast, reducing other types of listed subsidies and introducing new marketing/transport export subsidies would come close to 'circumvention'.

[1824] For those WTO Members 'with no base or annual commitment levels shown in Section II of Part IV of their Schedule, an annual notification following the end of the year in question should be made no later than 30 days following the period in the form of a statement confirming that no export subsidies exist or*, in the case of developing country Members using exempt export subsidies (Article 9:1(d) and (e))*, in the form of Supporting Table ES:2' (emphasis added). Committee on Agriculture, *Notification Requirements and Formats* (G/AG/2, 30 June 1995), at 24; *Notification Requirements and Formats under the WTO Agreement on Agriculture* (PC/IPL/12, 2 December 1994), at 28; Committee on Agriculture*, Special Session, Export Subsidy Commitments, Note by the Secretariat, Revision* (TN/AG/S/8/Rev.1, 2 February 2005), at 10-14.

[1825] China explicitly committed not to maintain or introduce any export subsidy upon agricultural products. *Report of the Working Party Report on the Accession of China* (WT/ACC/CHN/49), para 241.

[1826] Hoekman and Messerlin also seem to share this interpretation. See B. Hoekman and P. Messerlin, 'Removing the exception of agricultural export subsidies', in K. Anderson and W. Martin, *Agricultural Trade Reform and the Doha Development Agenda* (Washington DC: The World Bank, 2006), 195-219, at 197.

[1827] The situation is also different under the broad reading with respect to scheduled agricultural products given that these could even be offered above the level specified in a Member's schedule (pre-commitment level). Compare to above n 1819.

developing countries have offered both types of export subsidies by relying on Article 9.4.[1828] These countries' advocacy to prolong application of Article 9.4 also reveals their convinction that they can benefit from this provision. Moreover, when acceding to the WTO, Algeria, Cambodia, and Tonga did not schedule agricultural products but they all explicitly referred to their right to take recourse to Article 9.4 of the Agreement on Agriculture.[1829] This broad reading could likewise find contextual support in the anti-circumvention condition. Indeed, the reference to '*reduction* commitments' might indicate that the previous reference in the same provision to 'commitments' *as such* was not unintended and should be given meaning.[1830] Overall, the arguments underpinning this broad reading seem to be convincing. Yet, operationalizing the anti-circumvention condition imposed under Article 9.4 is even more difficult than under the narrow reading. After all, this condition is by its terms only meaningful for agricultural products subject to *reduction* commitments (i.e., scheduled agricultural products). Hence, developing countries having no scheduled agricultural products could not be restrained by this anti-circumvention condition when introducing marketing and transport export subsidies. Simultaneously imposing the anti-circumvention

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[1828] *Trade Policy Review, Report by the Secretariat, Republic of Korea, Revision* (WT/TPR/S/204/Rev.1, 4 December 2008), at 38; *Trade Policy Review Body, Trade Policy Review, Report by the Secretariat, Pakistan, Revision* (WT/TPR/S/193/Rev.1, 20 May 2008), at 81-82; *Trade Policy Review Body, Barbados, Report by the Secretariat* (WT/TPR/S/101, 10 June 2002), at 50. With regard to Korea, see also *Summary Report of the Meeting Held on 26 September 2007, Note by the Secretariat* (G/AG/R/49, 19 November 2007), at 10-11. Notifications referring to the use of Article 9.4 include: Committee on Agriculture, *Notification, Republic of Korea, Export Subsidy* (G/AG/N/KOR/36, 27 February 2007); *Notification, Morocco, Export Subsidies* (G/AG/N/MAR/33, 7 January 2005); *Notification, India, Export subsidies* (G/AG/N/IND/3, 1 March 2002). In addition, four developing countries (Korea, Morocco, Pakistan and Tunisia) – none of which had scheduled agricultural products – notified the use of export subsidies under this provision in 1998. *Note by the Secretariat, Information on the Utilization of Special and Differential Treatment Provisions,* (WT/COMTD/W/77/Rev.1/Add.4**,** 7 February 2002). All notifications during the 1995-2001 period are listed in Committee on Agriculture, *Special Session, Export Subsidy Commitments, Note by the Secretariat, Revision* (TN/AG/S/8/Rev.1, 2 February 2005), at 10-14.

[1829] See *Working Party on the Accession of Tonga, Draft Report of the Working Party on the Accession of the Kingdom of Tonga to the World Trade Organization, Revision* (WT/ACC/SPEC/TON/4/Rev.1, 23 October 2003), at 31; *Working Party on the Accession of Cambodia, Draft Report of the Working Party on the Accession of Cambodia, Revision* (WT/ACC/SPEC/KHM/4/Rev.1, 19 June 2003), at 47; *Working Party on the Accession of Algeria, Accession of Algeria, Additional Questions and Replies, Addendum* (WT/ACC/DZA/15/Add.2, 18 April 2004), at 10; see also, *Working Party on the Accession of Viet Nam, Accession of Viet Nam, Additional Questions and Replies* (WT/ACC/VNM/29, 30 October 2003), at 37.

[1830] Somewhat parallel, the Appellate Body has interpreted the term 'export subsidy commitments' in Article 10.1 of the Agreement on Agriculture as covering both scheduled and unscheduled products. Two arguments used by the Appellate Body can be transposed to the analysis under Article 9.4. First, the Appellate Body found support for its interpretation in the ordinary meaning of 'commitment' which generally connoted 'engagements' or 'obligations'. Second, the Appellate Body observed the distinction in Article 10 between 'export subsidy commitments' (paragraph 1) and 'reduction commitments' (paragraph 3). The latter only applies to scheduled agricultural products. Hence, the absence of the prefix 'reduction' is given meaning in the jurisprudence. See Appellate Body Report, *US – FSC*, paras 144-147; Panel, *US – FSC*, paras 7.138-7.140. The Panel in particularly stated (para 7.140) that '(w)e cannot assume that this distinction between two provisions in such close proximity within the same Article was inadvertent'.

condition upon scheduled agricultural products, along the lines elaborated above, seems to be somewhat paradoxical. It would mean that countries that in principle have more leeway to offer listed export subsidies would be more constrained in offering marketing/transport export subsidies than developing countries having no scheduled products. In sum, giving substance to the anti-circumvention condition, which by definition only disciplines scheduled products, is even thornier under the broad reading of Article 9.4 than under the narrow reading.[1831]

6.2.1.2.1.3. Conclusion and Doha Round negotiations

WTO Members are in principle only entitled to offer listed types of export subsidies to *scheduled* agricultural products and this up to their final reduction commitment level as agreed upon in the Uruguay Round. As a consequence, *unschedule*d agricultural products could not benefit from listed types of export subsidies. However, some more flexibility is given to developing countries with regard to transport and marketing export subsidies. Under the narrow reading, such export subsidies could be given by developing countries to scheduled agricultural export subsidies above their final reduction commitment level. For the reasons set out above, I would endorse the broad reading suggested by most Members, implying that all developing countries (except for China) are free to offer these types of export subsidies with respect to scheduled as well as unscheduled agricultural products. Only the anti-circumvention condition would impose some restraint but the exact meaning of this condition is far from evident.

In the latest Revised Draft Modalities for Agriculture, developed WTO Members having scheduled export subsidy entitlements agreed to eliminate these by the end of 2013, whereas developing WTO Members agreed to eliminate these by the end of 2016.[1832] Partly on demand of the Cotton-4, which is a West African coalition seeking liberalization in cotton,[1833] listed export subsidies for cotton would be prohibited without any phasing-out period for developed countries and developing countries would receive one year to implement this prohibition. Furthermore, in line with the Hong Ministerial Declaration, developing country Members ‘shall continue to benefit from the provisions of Article 9.4 of the Agreement on Agriculture until the end of 2021, i.e., five years after the end-date for elimination of all forms of export subsidies’.[1834] This formulation likewise suggests that all developing countries (except for China) benefit from S&D treatment under Article 9.4. Under Part III of this

[1831] As mentioned above, this is exactly the argument why the anti-circumvention condition might also be read as contextual support in favour of the narrow reading.
[1832] Revised Draft Modalities for Agriculture, above n 652, paras 162-163.
[1833] Benin, Burkina Faso, Chad, and Mali.
[1834] Revised Draft Modalities for Agriculture, above n 652, para 164. See above n 649.

dissertation, more insights will be given on why the EC finally agreed with this 2013 phase-out deadline. Likewise, it will be illustrated that this agreed deadline is conditional upon the elaboration of 'parallel' disciplines on non-listed types of export subsidies (e.g., export credit support, food aid). Obviously, the implementation of this agreed deadline in the negotiations is dependent on the final conclusion of the Doha Round. In the next section, the disciplines on non-listed types of export subsidies are elaborated.

6.2.1.2.2. Non-listed types of export subsidies

6.2.1.2.2.1. Scope

Those '*export subsidies* not listed in paragraph 1 of Article 9' are subject to the anti-circumvention discipline of Article 10.1 of the Agreement on Agriculture.[1835] As mentioned above, the term 'export subsidies' is defined in Article 1(e) as 'subsidies contingent upon export performance, *including* the export subsidies listed in Article 9 of this Agreement'. The use of the word 'including' suggests in the Appellate Body's reading that the term 'export subsidies' should be interpreted broadly.[1836] Again, the definition of a subsidy as formulated by the Appellate Body is relied upon. So, 'subsidies' refer to transfers of economic resources from the grantor to the recipient for less than full consideration. Contextual support is further found in Article 1 *juncto* 3 and/or the Illustrative List of the SCM Agreement.[1837] In addition to these provisions of the SCM Agreement, it could be argued that the list of deemed export subsidies under Article 9.1 of the Agreement on Agriculture could likewise offer useful contextual guidance on some definitional aspects. Relevantly, this might point to another interpretation of 'export subsidies' under Article 10.1. Indeed, the debate articulated above on the required nexus to the government of a payment made by a private actor in *Canada – Dairy* clearly illustrates that the choice among these provisions as contextual support could be relevant.[1838] It was explained that the strength of the nexus under Article 9.1(c) of the Agreement on Agriculture could be looser than under the relevant provisions of the SCM Agreement. The Appellate Body's definition of 'subsidies', which does not explicitly refer to 'by the government' but to the general concept of 'grantor', leaves it open to define 'export subsidies' under Article 10.1 in such a broad way.

The case law has further revealed that *all* such 'export subsidies' within the meaning of the Agreement on Agriculture that are not included in the list of Article 9.1 are subject to the non-circumvention discipline. As will be elaborated in the case study under Part III, subsidized

[1835] Article 10.1 of the Agreement on Agriculture (emphasis added).
[1836] Appellate Body Report, *US – Upland Cotton*, para 615.
[1837] For example, the Appellate Body in *US – FSC* found contextual support in Article 1 of the SCM Agreement.
[1838] See above Part II, Chapter 6, Section 6.2.1.2.1.1.2 and Chapter 4, Section 4.1.1.2.1.

export credit support is also subject to this discipline, even though Article 10.2 of the Agreement on Agriculture devotes a specific paragraph to this type of export subsidies. Revenue foregone by the government contingent upon exportation is another example of a non-listed type of export subsidies covered under Article 10.1. Indeed, the Appellate Body in *US –FSC* found that the US income tax exemption for FSCs qualified as an 'export subsidy' in the meaning of Article 10.1 of the Agreement on Agriculture.[1839]

All these non-listed types of export subsidies are only inconsistent with Article 10.1 if 'applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments'.[1840] In the following section, the case law's interpretation of this 'anti-circumvention' obligation imposed under Article 10.1 is explained.

6.2.1.2.2.2. Disciplines

6.2.1.2.2.2.1. Actual circumvention

According to the Appellate Body, Article 10.1 of the Agreement on Agriculture is 'designed to prevent Members from circumventing or "evading" their "export subsidy commitments"'.[1841] But the provision itself does not illuminate how this standard of 'anti-circumvention' should exactly be understood. Recall that listed types of export subsidies could be offered up to the level of reduction commitments for scheduled products but are flatly prohibited for non-scheduled products.[1842] When are these export subsidy commitments *circumvented* by the provision of non-listed types of export subsidies to such scheduled or non-scheduled agricultural products?

The literature was divided on how this question had to be answered. On the one hand, some authors, such as Desta, considered that the standard of anti-circumvention imposed on non-listed export subsidies should certainly be *lower* than the standard imposed on listed types of export subsidies. After all, its purpose is 'only to protect the commitments on those exhaustively listed export subsidies from being evaded by the use of non-listed subsidies'.[1843] Although acknowledging opposing textual arguments (e.g., Article 10.3), Desta argued that such circumvention should not be deemed present if non-listed export subsidies are given

[1839] Appellate Body Report, *US – FSC*, paras 133-142. Notice that it was not examined (because this was not claimed) whether this measure could have been covered under Article 9.1(c) of the Agreement on Agriculture. Interestingly, the Appellate Body referred to its interpretation in *Canada – Dairy* that 'revenue foregone' could be covered as 'payment' under Article 9.1(c) to underpin its decision that an export subsidy under Article 10.1 of the SCM Agreement could also include 'revenue foregone'. Appellate Body Report, *US – FSC*, para 138.
[1840] Appellate Body Report, *US – FSC*, para 626.
[1841] Appellate Body Report, *US – FSC*, para 148.
[1842] Abstraction is made of the exception for developing countries under Article 9.4 (see below Part II, Chapter 6, Section 6.2.1.2.2.2.3).
[1843] Desta, above n 632, at 263.

above commitment levels because this would put non-listed subsidies on the same footing as listed ones. Moreover, if such reading would have been the drafters' purpose, they would have been much more explicit in Article 10.1. Therefore, Desta concluded that the provision of non-listed export subsidies in excess of commitment levels should only create a rebuttable presumption of circumvention.[1844] On the other hand, Brosch, who was part of the negotiating team of the US during the Uruguay Round, considered Article 10.1 as a 'catch-all'-provision. It would cover export subsidy schemes not anticipated by the negotiators during the Uruguay Round. Hence, this reading would support the view to put non-listed types of export subsidies on an *equal* footing with listed ones.[1845]

The Panel in *Canada – Milk* followed the interpretation advanced by Brosch as it considered 'one example' of such (threat of) circumvention a situation where non-listed types of subsidies are given to scheduled products in excess of the reduction commitment level.[1846] The Panel observed that all parties agreed with this interpretation. The Panel also found contextual support in Article 10.3 which, as elaborated below, shifts the burden of proof to the respondent to demonstrate that no 'export subsidy, whether listed in Article 9 *or not*'[1847] is given in respect of the quantity the Member has exported in excess of its reduction commitment level. Taking a somewhat more flexible stance advocated by Desta, the Panel in the second compliance of *Canada – Milk* seemed to hold that the provision of non-listed export subsidies in excess of the reduction commitment level only makes a *prima facie* case of (threat of) circumvention, which can still be rebutted by the respondent.[1848] Yet, at the time of this second compliance panel, the Appellate Body in *US – FSC* had already dealt with this legal question in a way more in line with the original panel. Indeed, to paraphrase the Appellate Body's parallel reasoning as regards scheduled products: '(m)embers would have

[1844] Desta, above n 632, at 260-267; Desta, 'Legal Issues in International Agricultural Trade, The Evolution of the WTO Agreement on Agriculture from its Uruguay Origins to its Post-Hong Kong Directions', above n 1815, at 19.

[1845] But Brosch even goes further and labels non-listed export subsidies as prohibited *as such*, even if offered below commitment levels. Yet, the latter restrictive view, disciplining non-listed export subsidies far more *stricter* as listed once, certainly contradicts with the text of Article 10.1 which only prescribes that such types of subsidies could not be used to 'circumvent' export subsidy commitments and not that they are prohibited as such. Unsurprisingly, this view is not followed in the case law.

[1846] Panel Report, *Canada – Dairy*, paras 7.122 and 7.20. The reference to 'one example' indicates that the Panel left open the possibility that (threat of) circumvention by non-listed types of export subsidies could occur even when the reduction commitment level is not surpassed. This could also be inferred from the Panel's statement that 'a Member may use export subsidies not listed in Article 9.1 *within the limits of its scheduled reduction commitments*. However, as stipulated by Article 10.1, *such* subsidies may not be applied so as to circumvent these and other export subsidy commitments under the Agreement on Agriculture'. Hence, the 'circumvention' discipline would even be more stringent than the reduction commitment standard. Panel Report, *Canada – Dairy*, para 7.29.

[1847] Emphasis added.

[1848] The Panel's interpretation seems to result from an erroneous reading of Article 10.3 as the latter only shifts the burden of proof on the respondent with respect to the export subsidy element and not with respect to the anti-circumvention standard. Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, paras 5.166-5.173.

found "a way round", a way to "evade", their commitments under Articles 3.3 and 9.1, if they could transfer, through (non-listed types of export subsidies), the very same economic resources that they were, (…), prohibited from providing through other methods under the first clause of Article 3.3 and under 9.1' when the specific reduction commitment levels have been reached.[1849,1850] Hence, the Appellate Body seemed to hold that circumvention is present, and not merely assumed, when non-listed types of export subsidies are offered to scheduled products above their reduction commitment levels or to unscheduled products *tout court*. At the same time, the Appellate Body seemed to hold that *no* circumvention could be present in case Members do not offer non-listed export subsidies to scheduled products above their reduction commitment levels.[1851] This interpretation was applied and confirmed by the panels in the *US – Upland Cotton* procedures. As a result, non-listed export subsidies are thus disciplined similarly under the 'anti-circumvention' standard of Article 10.1 than listed ones under Articles 3.3 *juncto* 9.1 of the Agreement on Agriculture. Non-listed types of export subsidies are flatly prohibited for unscheduled products. Such subsidies are added to listed types of export subsidies for the determination of whether scheduled products are subsidized above quantity/budgetary outlay reduction commitments.

6.2.1.2.2.2.2. Threat of circumvention

Actual circumvention of export subsidy commitments is not even required to find an Article 10.1 violation. Indeed, the text of Article 101 indicates that the application of an export subsidy in a manner which only *threatens* circumvention is sufficient.[1852] If 'actual' circumvention is found with respect to an agricultural product, panels are allowed to exercise judicial economy on the additional claim of 'threat' of circumvention.[1853] Hence, the claim that non-listed types of subsidies *threaten* to lead to circumvention of export subsidy commitments is merely scrutinized for those agricultural products for which actual

[1849] The phrase 'at that time' refers to the situation when the specific reduction commitment levels have been reached. Appellate Body Report, *US – FSC*, para 152.

[1850] Similarly, the Appellate Body reasoned as regards to non-scheduled products, that 'Members would certainly have "found a way round", a way to "evade"' the prohibition on providing listed types of export subsidies to non-schedules products 'if they could transfer, through (*non-listed types of export subsidies*), the very same economic resources that they are prohibited from providing in other forms under Articles 3.3 and 9.1'. Appellate Body Report, *US – FSC*, para 150.

[1851] This could also be revealed from the Appellate Body's general statement in *Canada – Dairy (Article 21.5 – New Zealand and US II)* that '(p)ursuant to Article 3 of the *Agreement on Agriculture*, a Member is *entitled* to grant *export subsidies* within the limits of the reduction commitment specified in its Schedule' (Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US II),* para 70). This differs from the Panel's holding in the original procedure which left open the possibility that circumvention could be present even if the reduction commitment levels are not reached. See above n 1846.

[1852] Appellate Body Report, *US – FSC*, paras 148-154.

[1853] Appellate Body Report, *US – Upland Cotton*, paras 715-719; Panel Report, *US – Upland Cotton*, para 7.882 (footnote 1061). According to the Panel, subsidies that result in actual circumvention *ipso facto* threaten to result in circumvention.

circumvention could not be demonstrated. Such a threat of circumvention was, in the Panel's interpretation in *US – Upland Cotton*, only present if the subsidy programme created the unconditional legal entitlement to receive them.[1854] However, the Appellate Body rejected the Panel's narrow interpretation which seems, as the Appellate Body also hinted at, to be inspired by the mandatory/discretionary distinction.[1855,1856] According to the Appellate Body, 'the ordinary meaning of the term "threaten" refers to a *likelihood* of something happening' and 'does not connote a sense of certainty'.[1857] Therefore, 'threaten to lead to circumvention' is present in case 'the export subsidies are applied in a manner that is "*likely to*" lead to circumvention of a WTO Member's export subsidy commitments'.[1858] On the one hand, contrary to the Panel, the Appellate Body 'did not foreclose (…) the possibility that a measure that does not create a "legal entitlement" or that has a "discretionary element" could be found to "threaten[] to lead to circumvention" (…)'.[1859] On the other hand, a threat of circumvention is not interpreted as broadly as to mandate 'precautionary steps to ensure that circumvention of (…) export subsidy reduction commitments never happens'.[1860] The standard of 'likelihood' is situated somewhere in between both extremes and should – unsurprisingly – be analyzed on a case-by-case basis.[1861] A pivotal element to reveal the likelihood of circumvention in the future seems whether the product in question has previously benefited from the challenged non-listed type of export subsidy.[1862]

Hence, a threat of circumvention could exist even if its current legal system does not mandate the Member in question to offer such WTO inconsistent subsidies in the future. In developing its broad interpretation, the Appellate Body observed that its interpretation of the term 'threat' is consistent with its approach under the Agreement on Safeguards and the Anti-Dumping Agreement where it defined a threat as something that 'has not yet occurred, but remains a future event whose actual materialization cannot, in fact, be assured with certainty'.[1863] However, the Appellate Body seems to overlook that *threat* of circumvention elaborated in Article 10.1 has another quality than the *threat* of injury that could be countervailed (or which could be responded by imposing anti-dumping duties or safeguard duties).[1864] Contrary to the threat referred to in Article 10.1, in the latter case subsidization (dumping/increased imports)

[1854] Panel Report, *US – Upland Cotton*, para 7.883.
[1855] The Panel erroneously generalized the Appellate Body's reference to 'legal entitlement' in *US – FSC*. Appellate Body Report, *US – Upland Cotton*, paras 706-710.
[1856] The application of the mandatory/discretionary distinction is explained below in Part III, Chapter 4, Section 4.1.
[1857] Appellate Body Report, *US – Upland Cotton*, para 704 (emphasis in the original).
[1858] Appellate Body Report, *US – Upland Cotton*, para 704 (emphasis added).
[1859] Appellate Body Report, *US – Upland Cotton*, para 709.
[1860] Appellate Body Report, *US – Upland Cotton*, para 713.
[1861] Appellate Body Report, *US – Upland Cotton*, para 704 (footnote 1082).
[1862] Appellate Body Report, *US – Upland Cotton*, paras 713-714.
[1863] Appellate Body Report, *US – Upland Cotton*, para 705.
[1864] See also above Part II, Chapter 5, Section 5.2.2.2.5.

actually takes place and there is only uncertainty on whether it will cause the required level of *injury*. On the other hand, one might argue that the Appellate Body's interpretation acknowledges that a threat of future subsidization might affect actual behaviour of foreign producers, even though the current regulatory framework does not mandate such future subsidization.

6.2.1.2.2.2.3. Conclusion

The case law has largely neutralized the distinction often stressed in the literature between disciplines on listed and non-listed types of export subsidies. The standard of actual anti-circumvention imposed on non-listed export subsidies under Article 10.1 is exactly the same as the (reduction) commitment standard imposed on listed export subsidies under Articles 3.3 *juncto* 9.1. Although Article 10.1 might have been drafted differently if this interpretation was indeed in the mind of the drafters,[1865] this interpretation spells out a clear-cut standard for which Article 10.3 offers contextual support. Moreover, this reading was not contested by any of the WTO Members involved in the above-mentioned cases (including the main export subsidizers the EC and the US).[1866] Hence, WTO Members are not allowed to grant '*any subsidy whatsoever to exports* of unscheduled products' [1867] and of scheduled products above their reduction commitment level. What is more, non-listed export subsidies are even disciplined more stringently as listed ones given that a *likelihood* of such circumvention ('threat of circumvention') caused by such non-listed subsidy suffices to find an inconsistency with Article 10.1 of the Agreement.[1868]

Yet, should this general conclusion not be nuanced with respect to developing countries? Under the broad interpretation of Article 9.4, these countries are free to offer marketing and transport export subsidies. How does their right to offer these two listed types of subsidies to (un)scheduled products influence the determination of (threat of) circumvention of export subsidy commitments? Put otherwise, how can they circumvent export subsidy commitments

[1865] The Modalities Paper also stipulated that '(t)he export subsidies *listed in Annex 7 (listed types of export subsidies) shall* be subject to budgetary outlay and quantity commitments'(Modalities Paper, above n 1804, para 11, emphasis added). Notice that the Appellate Body seems to attach little relevance to this Modalities Paper (see Appellate Body Report, *EC – Export Subsidies on Sugar*, para 199).
[1866] See, for example, Panel Report, *US – Upland Cotton*, para 7.921.
[1867] Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, footnote 782. According to the Panel, this is stipulated under Article 3.3 of the Agreement on Agreement. However, the text of article 3.3 only deals with listed types of export subsidies on (un-)scheduled products. The general obligation on listed as well as non-listed types of export subsidies is Article 8 of the Agreement on Agriculture.
[1868] Foreclosing this conclusion might have been the reason why the original Panel read 'threat of circumvention' in a narrow way. This reading was indeed in line with the mandatory/discretionary distinction.

by using non-listed types of export subsidies if they are allowed, without clear limitation,[1869] to offer two types of listed export subsidies? Two opposite readings could again be articulated. If one read article 10.1 as implicitly imposing a lower standard on non-listed export subsidies, the argument could be advanced that, next to the two listed types of export subsidies (marketing/transport export subsidies), developing countries are *a fortiori* free to offer non-listed types of export subsidies to scheduled and unscheduled products. However, the opposite reading seems more plausible in light of the case law's reading of Article 10.1 given that it disciplines non-listed export subsidies even more strictly than listed ones.[1870] This interpretation, which would also give substance to Article 10.1 regarding developing countries, would discipline non-listed export subsidies similar to listed ones that are not covered under Article 9.4. Hence, listed as well as non-listed subsidies for unscheduled products are prohibited except for marketing/transport export subsidies. For the determination of whether scheduled products respect reduction commitments and the anti-circumvention obligation, listed and non-listed export subsidies are added up[1871] but marketing and transport export subsidies should be subtracted again. This reading implies that developing countries having no scheduled agricultural products could also not offer any non-listed types of export subsidies for agricultural products and that a threat thereof would even be sufficient to find a WTO inconsistency.

6.2.1.2.3. Non-commercial transactions: Food aid

Next to non-listed types of export subsidies, 'non-commercial transactions' could not be used by WTO Members to circumvent export subsidy commitments (Article 10.1 of the Agreement on Agriculture). In principle, such 'non-commercial transactions', a concept not further defined in the Agreement, seem subject to the same anti-circumvention standard as non-listed types of export subsidies. However, a specific regime applies to international food aid transactions.

The Appellate Body in *US – Upland Cotton* has confirmed that food aid transactions are covered by Article 10.1 under the concept of 'non-commercial transactions' and emphasized that WTO Members 'are free to grant as much food aid as they wish, provided that they do so consistently with Articles 10.1 and 10.4'.[1872] To be sure, the disciplines imposed under

[1869] Recall that Article 9.4 is also subject to an 'anti-circumvention' obligation.
[1870] Otherwise, developing countries would also be free to provide all other types of non-listed export subsidies (e.g., tax exemptions contingent upon exportation).
[1871] Alternatively, the quantities of the product in question benefiting from such export subsidies are added up.
[1872] The Appellate Body agreed with Brazil that '"Article 10.4 provides an example of specific disciplines that have been agreed upon for a particular type of measure and that *complement* the general

Article 10.1 and 10.4 are not treated as separate and complementary by the Appellate Body. The obligation of non-circumvention under Article 10.1 seems to be *determined* on the basis of the disciplines set out in Article 10.4 with respect to international food aid: 'article 10.4 provides specific disciplines that may be relied on to determine whether international food aid is being "used to circumvent" a WTO Member's export subsidy commitments'.[1873] Hence, the Appellate Body brings food aid transactions under the scope of Article 10.1 (as 'non-commercial transactions') but the obligation of 'non-circumvention' is interpreted in light of Article 10.4 of the Agreement on Agreement.

As a result, the relevant disciplines imposed on international food aid transactions[1874] are spelled out under Article 10.4 of the Agreement on Agriculture:

> Members donors of international food aid shall ensure:
> (a) that the provision of international food aid is not tied directly or indirectly to commercial exports of agricultural products to recipient countries;
> (b) that international food aid transactions, including bilateral food aid which is monetized, shall be carried out in accordance with the FAO "Principles of Surplus Disposal and Consultative Obligations", including, where appropriate, the system of Usual Marketing Requirements (UMRs); and
> (c) that such aid shall be provided to the extent possible in fully grant form or on terms no less concessional than those provided for in Article IV of the Food Aid Convention 1986.

Regarding the scope of Article 10.4, observe that the concept of 'food aid' is not explicitly defined in the Agreement on Agriculture. In general terms, food aid refers to commodities provided by international donors on concessional (i.e., below market) terms.[1875] In fact, Article 10.4(c) spells out the required level of concessionality to label a particular transaction as 'food aid' under the Agreement on Agriculture: aid shall be provided only 'to the extent possible' in fully grant form and, at minimum, on terms no less concessional than those

export subsidy rules" but, like Article 10.2, it does *not* "*establish any exceptions* for the measures that (it) covers"' (para 619; emphasis added). Hence, the Appellate Body does not formally consider Article 10.4 as a *lex specialis* regarding food aid transactions that would exempt it from the general rule of Article 10.1. Appellate Body Report, *US – Upland Cotton*, para 619.

1873 Appellate Body Report, *US – Upland Cotton*, para 619.

1874 The concept of 'food aid' is used in this section to refer to 'international food aid'. Hence, it excludes food aid given by a WTO Member to its own citizens, which are disciplined under domestic support provisions (see below Part II, Chapter 6, Section 6.2.2.1).

1875 Three types of food aid are distinguished by the World Food Programme: (i) *programme food aid*: 'food aid provided on a government-to-government basis. It is not targeted at specific beneficiary groups. It is sold on the open market and can be provided either as a grant or as a loan'. It often takes the form of subsidized exports credits given to the recipient country; (ii) *project food aid*: 'food aid provided to support various type of projects such as agricultural, nutritional and development. It is usually freely distributed to targeted beneficiary groups. However it can also be sold on the open market. Project food aid is provided on a grant basis and is channeled bilaterally, multilaterally or through NGOs'. (iii) *emergency food aid*: 'food aid provided to victims of natural or man-made disasters on a short-term basis. It is freely distributed to targeted beneficiary groups and is usually provided on a grant basis. It is channeled multilaterally, through NGOs or, sometimes, bilaterally'. See World Food Programme, *Food Aid Information System, Glossary and Abbreviations* (available at: http://www.wfp.org/fais/quantity-reporting/glossary).

provided for in Article IV of the Food Aid Convention 1986. The threshold question on the level of concessionality to qualify as a non-commercial, food aid transaction is thus solved by reference to Article IV of the 1986 version of the Food Aid Convention (FAC), which stipulates that:

> Food aid under this Convention may be supplied on any of the following terms:
> (a) gifts of grain
> (b) gifts or grants of cash to be used to purchase grains for the recipient country;
> (c) sales of grains for the currency of the recipient country, which is not transferable and is not convertible into currency or goods and services for use by the donor member;
> (d) sales of grain on credit, with payment to be made in reasonable annual amounts over periods of 20 years or more and with interest at rates which are below commercial rates prevailing in world markets.
> (e) on the understanding that such aid shall be supplied to the maximum extent possible by way of gifts, especially in the case of least-developed countries, low *per capita* income countries and other developing countries in serious economic difficulties.

Accordingly, food aid could be provided in the form of actual food (also called 'direct transfers' or in-kind food aid) or in the form of cash to be exchanged for food. The required level of concessionality is strengthened under the 1999 amendment of the FAC.[1876] Instead of simply urging that aid shall to the extent possible take the form of gifts (Article IV(e) FAC 1986)), the FAC 1999 specifies that:

> (…) (b)With respect only to food aid counted against a member's commitment, *all food aid provided to least-developed countries shall be made in the form of grants*. (c) Food aid under this Convention provided in the form of grants shall represent not less than 80 per cent of a member's contribution and, to the extent possible, members will seek progressively to exceed this percentage.[1877]

However, given that Article 10.4(c) of the Agreement on Agriculture explicitly refers to the 1986 version, the obligation to provide food aid to LDCs in grant form seems not to be enforceable under the WTO.[1878]

The other two obligations listed in Article 10.4 [(a), (b)], which were taken word for word from the FAC 1995[1879], aim to ensure that such non-commercial food aid transactions do not distort commercial food transactions. First, international food aid should not be 'tied' directly or indirectly to commercial exports of agricultural products (Article 10.4(a)). In such 'tied food aid'-transactions, donor countries would require the recipient countries to accept commercial food transactions from the donor country as a condition for receiving the food

[1876] The scope of eligible products is also no longer restricted to grains (see Article IV FAC 1999).
[1877] Article IX(c),(d) FAC 1999 (emphasis added).
[1878] Note that the FAC would normally have been renegotiated in 2002 but negotiations have been put on hold pending the Doha negotiations. See *Report by the Committee on Agriculture to the General Council* (G/AG/16/Add.1, 13 June 2006), para 5; S. Murphy and K. McAfee, 'US Food Aid: Time to Get It Right', *Institute for Agriculture and Trade Policy* (July 2005), 38 pp., at 15.
[1879] See M. G. Desta, 'Food Security and International Trade Law: An Appraisal of the World Trade Organization Approach', 35:3 *Journal of World Trade* (2001), 449-468, at 462.

aid. However, as Desta highlights, this obligation does not prohibit donor countries to tie food aid transactions to non-agricultural transactions.[1880] For instance, the inefficient practice to tie food aid transactions to services from the donor country used for delivering such food aid is not disciplined. Hence, only one form of 'tied food aid'-transactions (i.e., tied to commercial food transactions) is disciplined under Article 10.4(a). Second, food aid transactions should in principle not replace commercial transactions but only satisfy additional consumption (i.e., consumption which would not have taken place in the absence of the food aid transaction). To this end, food aid has to respect the FAO Principles of Surplus Disposal (developed in 1954), which is 'a code of international conduct that encourages the constructive use of surplus disposal of agricultural commodities, while at the same time safeguarding the interest of commercial exporters and local producers'.[1881,1882] Next to notification requirements, these FAO Principles have put in place the system of 'Usual Marketing Requirements' (UMRs), which WTO Members only 'where appropriate' have to respect by virtue of Article 10.4(b). UMRs refer to the requirement upon the recipient importing country in a food aid agreement to maintain a normal level of commercial imports from the donor or other countries in addition to the level of food aid. Their rationale is to ensure the principle of additional consumption, but they only safeguard the commercial interests of donor or other exporting countries and not those of local producers.[1883]

As long as WTO Members respect these rather undemanding obligations set out under Article 10.4 of the Agreement on Agreement,[1884] they are free to grant as much food aid as they wish. In the current Doha Round, most WTO Members, led by the EC and the Cairns Group, have urged for new disciplines to effectively ensure that food aid transactions could not be used to circumvent export subsidy commitments, whereby they essentially target US food aid practices. The EC, in particular, has conditioned its agreement on the elimination of direct export subsidies (i.e., listed export subsidies) on tighter disciplines on food aid.[1885] The EC even proposed that in-kind food aid should be in fully grant form and should ultimately be

[1880] Desta, above n 1879, at 462.
[1881] See FAO, 'Food Aid in the Context of International and Domestic Markets and the Doha Round', *FAO Trade Policy Technical Notes on Issues Related to the WTO Negotiations on Agriculture – No. 8*, 9 pp., at 1.
[1882] FAO, *Reporting Procedures and Consultative Obligations under the FAO Principles of Surplus Disposal, A Guide for Members of the FAO Consultative Subcommittee on Surplus Disposal* (Rome, 2001).
[1883] See also FAO, above n 1881, at 2. For a criticism on the UMRs, see Desta, above n 1879, at 464-465.
[1884] According to Murphy and McAfee, these obligations 'had no impact on WTO Members' food aid practices'. Murphy and McAfee, above n 1878, at 16.
[1885] See also below Part III, Chapter 2, Section 2.2.

replaced by food aid in cash form.[1886] As the only major donor primarily relying on this form of food aid, the US does not want to rule out in-kind food aid. Moreover, the US firmly opposes a prohibition on its practice of 'monetization' of such in-kind food aid. Other WTO Members have criticized this US practice whereby in-kind food is sold (i.e., monetized) by NGOs in the recipient country to fund their development projects.[1887] Originally intended to merely cover NGOs' costs for handling food aid (e.g., storage costs), monetization has since the 1990s been used more widely to finance ongoing development projects.[1888] By increasing the supply in the recipient country, monetization is evidently market distorting for local production and commercial imports. Above, it fails to target that part of the population lacking the purchasing power to buy food and thus most in need of food aid.[1889]

The latest Revised Draft Modalities for Agriculture (December 2008) plainly reflects a compromise between these opposing interests but would, if adopted, definitively strengthen the disciplines on food aid in a substantive way.[1890] First, food aid will be defined more narrowly: it will have to be in fully grant form, not be tied to agricultural products as well as other goods or services from the donor country, and will in principle not be open for re-exportation. Such food aid that is in cash form and untied will be allowed *as such*, as it is by definition non trade-distorting.[1891] In-kind food aid will not have to be phased out. Yet, disciplines on such food aid will draw a useful distinction between food aid in case of emergency situations (safe box) and in non-emergency situations. In-kind food aid will be allowed in case an emergency situation is declared[1892] and a need assessment is made coordinated under the United Nations or the Red Cross. Such a safe box should be welcomed because food aid in emergency situations not only responds to genuine food security concerns in the recipient country, but will likely not replace commercial imports and local production (principle of additional consumption). In all other situations, three conditions will have to be

[1886] See also ICTSD, 'AG: Disagreements Still Remain On Export Competition', 10:17 *Bridges Weekly Trade News Digest* (17 May 2006),
[1887] See, for example, discussions on this US practice in the following WTO documents: G/AG/R/35, 26 August 2003; G/AG/R/38, 28 May 2004; G/AG/R/39, 16 July 2004; G/AG/R/40, 26 October 2004.
[1888] The US itself estimated that approximately 22 per cent, 14 per cent and 17 per cent of its total food aid was monetized in the fiscal years 2004, 2005 and 2006, respectively. Yet, it emphasized that this food aid was in conformity with Article 10.4(b) of the Agreement on Agriculture. See *Note by the Secretariat, Summary Report of the Meeting Held on 12 March 2009* (G/AG/R/54, 25 May 2009), para 21.
[1889] Murphy and McAfee, above n 1878, at 29.
[1890] See Revised Draft Modalities for Agriculture, above n 652, Annex L. Annex L would replace the current Article 10.4 of the Agreement on Agriculture.
[1891] In case of food aid in cash form, 'untied' also means that the agricultural products bought with the cash should not be sourced from the donor country. Hence, it could by definition not circumvent export subsidy commitments as no incentive is given to source products from the donor country.
[1892] This could be declared by either the recipient country or the UN Secretary General. Alternatively, other countries, regional or international governmental organization, the Red Cross, and non-governmental humanitarian organizations could make an emergency appeal.

fulfilled: in-kind food aid must be based on a targeted assessment of need, provided to redress food deficit situations which give rise to chronic hunger, and be provided consistently with the objective of preventing, or at the very least minimizing, commercial displacement. Regarding the practice of 'monetization' of in-kind food aid, the US was successful to prevent a total prohibition in the draft text. Under the safe box (emergency situations), it shall only be accepted for food aid to LDCs where there is a demonstrable need to do so for the sole purpose of transport and delivery. More fundamentally, in non-emergency situations, 'monetization' would be allowed as means to meet direct nutrition requirements of LDCs or net food-importing developing countries. This would be the case if it is necessary to fund (i) 'the internal transportation and delivery of the food aid' or (ii) 'the procurement of agricultural inputs to low-income or resource-poor producers'. The second option would open the door for 'monetization' beyond what it is needed to cover the costs for handling food aid.

The rationale of the disciplines in Article 10.4 of the Agreement on Agriculture is to preserve the commercial interests of other exporting countries and local producers in the recipient countries. Indeed, the importance of the availability of food aid for reaching food security in recipient countries is not reflected in Article 10.4. Nonetheless, countries were well aware during the Uruguay Round that cuts in domestic support and export subsidies would likely lead to an increase in prices on the world market (at least in the short run), and thus negatively affect net-food importing countries.[1893] Above, as food aid often takes the form of surplus disposal in donor countries, cuts in these countries' levels of domestic support could also lead to lower levels of food aid.[1894] To respond to these concerns, Ministers adopted at the end of the Uruguay Round the Decision on Measures Concerning the Possible Negative Effects of the Reform Programme on Least-Developed and Net Food-Importing Developing Countries (NFIDC Decision).[1895] With regard to food aid to these countries, the NFIDC Decision commits Members to some general, non-substantive obligations: (i) to review the level of food aid under the FAC and initiate negotiations in the appropriate forum to establish a sufficient level of food aid; (ii) to adopt guidelines so that an increasing part of basic foodstuff is provided to LDCs and Net Food-Importing Developing Countries (NFDIC) on terms similar to those elaborated in Article 10.4(c); and (iii) 'to give full consideration' to requests

[1893] See also the final paragraph of the Preamble of the Agreement on Agriculture.
[1894] Desta, above n 1879, at 452.
[1895] See also Article 16 of the Agreement on Agriculture. LDCs are designated as such by the United Nations (Economic and Social Council). A developing country qualifies as a 'net-food importing developing country' (NFDIC) if it was a net importer of basic foodstuffs in any three years of the most recent five-year period for which data are available and notified the Committee on Agriculture of its decision to be listed as NFDIC for the purposes of the Decision (G/AG/3, 24 November 1995). For the list of countries currently qualifying as NFDIC, see G/AG/5/Rev.8, 22 March 2005.

for the provision of technical and financial assistance to these countries to improve their agricultural productivity and infrastructure.[1896] The first part of this Decision was implemented outside the WTO by renegotiating the FAC (1997-1999). Parties to the FAC agreed to increase their minimum annual levels of food aid commitments.[1897,1898] Further renegotiations of the FAC 1999 have, however, been put on hold pending the Doha negotiations.[1899] If the latest draft on agriculture would be adopted as part of a Doha deal, a non-mandatory commitment to ensure an adequate level of food aid would be inscribed under the WTO. Indeed, Annex L of this draft opens with:

> Members reaffirm their commitment to maintain an adequate level of international food aid (…), to take account of the interests of food aid recipients and to ensure that the disciplines contained hereafter do not unintentionally impede the delivery of food aid provided to deal with emergency situations.[1900]

Hence, the new text explicitly recognizes – but does not prevent – the potential perverse effect that stricter disciplines on food aid might lead to lower levels of such more genuine food aid. This effect seems not improbable given that the largest food aid donor, namely the US, will have to make the largest amendments to its food aid regime. The new regime would become far less beneficial to its own (non-)agriculture producers and service providers.[1901] Such potential perverse effect explains why, for instance, the ACP Group partly sides with the US on opposing stringent food aid disciplines in the negotiations.[1902] In sum, under the WTO, Members will thus remain free to grant as much food aid as they want as long as they respect the applicable disciplines under the Agreement on Agriculture, but they might equally opt to grant no food aid at all.

[1896] As Desta observed, the NFDIC Decision does neither create any concrete, enforceable rights for LDCs or NFIDCs, nor any specific obligations upon other WTO Members. For an in-depth discussion on the implementation, see Desta, above n 1879, at 455-457. See also McMahon, above n 1729, at 176-181.

[1897] The minimum aggregate amount is around 5.5 million tons in wheat equivalent. The actual level of food aid provided by FAC parties was well above this minimum level in recent years (e.g., period July 2008-June 2009: 7.5 million tons).

[1898] See Preamble and Part II of the FAC 1999. Parties to the FAC are: Argentina, Australia, Canada, European Union and its member States, Japan, Norway, Switzerland, and the US.

[1899] In the meantime, parties to the FAC extended the FAC 1999. The most recent extension came into effect on 1 July 2009. See also *Report by the Committee on Agriculture to the General Council* (G/AG/16/Add.1, 13 June 2006), para 5; Murphy and McAfee, above n 1878, at 15.

[1900] See Revised Draft Modalities for Agriculture, above n 652, Annex L.

[1901] Other large food aid donors generally conform already to this new set of disciplines. For the amount of food aid given by FAC parties over the period July 2008 – June 2009, see *Food Aid Operations, Report on Operations by Member of the Food Aid Convention, Prepared for the Food Aid Committee by the Secretariat of the International Grains Council* (February 2010), 201 pp. (available at: http://www.foodaidconvention.org/Pdf/annual_reports/faoperations_0809.pdf).

[1902] See, for example, *Minutes of the Meeting* (TN/C/M/27, 30 October 2007), at 67.

6.2.1.3. Burden of proof

As a general rule, 'the burden of proof rests upon the party, whether complaining or defending, who asserts the affirmative of a particular claim or defence'.[1903] Nonetheless, Article 10.3 provides a special rule for proof of certain export subsidies under the Agreement on Agriculture.[1904] It reads:

> Any Member which claims that any quantity exported in excess of a reduction commitment level is not subsidized must establish that no export subsidy, whether listed in Article 9 or not, has been granted in respect of the quantity of exports in question.

Elaborating upon its purpose, the Appellate Body has clarified that this provision 'pursues the aim of preventing circumvention of export subsidy commitments by providing special rules on the reversal of burden of proof where a Member exports an agricultural product in quantities that exceed its reduction commitment level'.[1905] Turning to its content, the Appellate Body continued that 'in such a situation a WTO Member is treated as if it has granted WTO *inconsistent* export subsidies for the excess quantities, unless the Member presents adequate evidence to "establish" the contrary'.[1906]

As a consequence, the reversal of the burden of proof, applicable in the original as well as compliance procedures,[1907] is triggered merely by exceeding the quantity reduction commitments.[1908] As a result, Article 10.3 'cleaves the complaining Member's claim in two'.[1909] In line with the general rule on the burden of proof, the complaining party has to prove, in the first place, that a quantity of an agricultural product is exported by the respondent in excess of its reduction commitment. If demonstrated, the burden right away shifts to the complainant who has to establish that no export subsidy has been granted to this excess quantity. So, the complainant is not required to make a *prima facie* case of export subsidization regarding this excess quantity.[1910]

[1903] Appellate Body Report, *US – Wool Shirts and Blouses*, at 14; Appellate Body Report, *US – Upland Cotton*, para 644. The Appellate Body has clarified that '(a) complaining party will satisfy its burden when it establishes a *prima facie* case by putting forward adequate legal arguments and evidence. (…) Once the complaining party has established a *prima facie* case, it is then for the responding party to rebut it'. Appellate Body Report, *Chile – Price Band System (Article 21.5 – Argentina),* para 134.
[1904] Appellate Body Report, *Canada – Dairy*, para 69.
[1905] Appellate Body Report, *US – Upland Cotton*, para 616. 'This reversal of the usual rules obliges the responding Member to bear the consequences of any doubts concerning the evidence of export subsidization. Article 10.3 thus acts as an incentive to Members to ensure that they are in a position to demonstrate compliance with their quantity commitments under Article 3.3'. Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, para 74.
[1906] Appellate Body Report, *US – Upland Cotton*, para 616 (emphasis in the original).
[1907] Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para 6.4.
[1908] Panel Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para 6.5; Panel Report, *US – FSC*, paras 7.136 and 7.161.
[1909] Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, para 71.
[1910] 'In practice, the complaining Member may wish to present evidence to rebut any evidence presented by the responding Member. However, the complaining Member is not required to lead in the

Four specifications should be made regarding the exact scope of Article 10.3. First, the text of this provision explicitly stipulates that it applies with respect to claims regarding listed as well as non-listed types of export subsidies. Accordingly, the specific burden of proof is applicable with regard to claims formulated under Article 9.1 (listed types) as well as under Article 10.1 (non-listed types).[1911]

Second, the text indicates that such a claim should relate to *export quantity* reduction commitments that are alleged to be exceeded and not to budgetary outlay commitments.[1912]

Third, differing from the Panel's intepretation in *US – Upland Cotton*, the Appellate Body concluded that its scope is confined to those agricultural products that are effectively scheduled and for which, as stipulated in Article 10.3, *reduction* commitments are therefore made.[1913] Bringing non-scheduled export subsidies within its scope would lead to 'an extreme result' as it would imply that 'any export of an unscheduled product is *presumed* to be subsidized'.[1914] But what if an export subsidy programme similarly operates with respect to both scheduled and unscheduled agricultural products and both are challenged at the same time, as happened in the *US – Upland Cotton* case?[1915] Concerning unscheduled products, the burden of proof for demonstrating that the export credit guarantees constituted export subsidies rested upon Brazil pursuant to the general rule, whereas, for scheduled products, the non-existence of export subsidization of the same type of guarantees had to be demonstrated by the US pursuant to the specific rule of Article 10.3.[1916] Acknowledging this difference, the compliance Panel in *US – Upland Cotton* decided that it would first proceed as if Brazil bore the burden of proof with respect to the subsidization element (i.e., as if Article 10.3 did not exist). Only if Brazil had failed to demonstrate this element, which was not the case,[1917] the Panel would have applied Article 10.3 to the claims regarding scheduled products and thus

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presentation of evidence to panels, and it might well succeed in its claim even if it presents no evidence (…)'. Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US II)*, paras 72-76.

[1911] As a result, Article 10.3 is relied upon as contextual support for the interpretation of 'circumvention' under Article 10.1 (see above Part II, Chapter 6, Section 6.2.1.2.2.2).

[1912] Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, footnote 635.

[1913] Appellate Body Report, *US – Upland Cotton*, paras 652, 681, footnote 1035.

[1914] The Appellate Body thus reversed the Panel's opposite interpretation. Appellate Body Report, *US – Upland Cotton*, paras 650-652. Given the fact that both 'export subsidies for both unscheduled agricultural products and industrial products are completely prohibited under the *Agreement on Agriculture* and under the *SCM Agreement*, respectively', the Panel's interpretation would imply that the burden of proof with regard to the same issue would apply differently under both agreements: 'it would be on the respondent under the *Agreement on Agriculture*, while it would be on the complainant under the *SCM Agreement*'. Appellate Body Report, *US – Upland Cotton*, para 652.

[1915] For example, as the Appellate Body in the compliance procedure observed, '(t)he new fee structure applies to export credit guarantees provided to all eligible commodities under the revised GSM 102 programme; individual guarantees are issued under the same terms and conditions and no distinction is made on a commodity-specific basis'. Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 203.

[1916] Appellate Body Report, *US – Upland Cotton*, footnote 1035.

[1917] Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, footnote 765.

required the US to establish that no export subsidies were given with respect to the excess quantities of these scheduled products.[1918]

Fourth and finally, Article 10.3 only applies with regard to claims of export subsidization brought under the Agreement on Agriculture and not on alternative claims formulated under the SCM Agreement.[1919] Given that the claim on export subsidization is first addressed under the Agreement on Agriculture but also taken into consideration that the SCM Agreement's subsidy standards are hereby often relied upon (e.g., item (j)), the shift to the general rule on the burden of proof for the alternative claim under the SCM Agreement might not always be relevant.[1920] Applied to the *US – Upland Cotton* case, once the US had failed to demonstrate that the standard of item (j) of the Illustrative List was met with respect to scheduled products for the purpose of the claim under Article 10.1 of the Agreement on Agreement, it was not very difficult for Brazil to subsequently demonstrate a direct violation of item (j) with regard to its claim under the SCM Agreement.[1921]

In sum, Article 10.3 operates where a claim is formulated under the Agreement on Agriculture that an export quantity commitment is violated by the provision of listed or non-listed export subsidies to scheduled agricultural products. Once the complainant has demonstrated that an excess quantity of a scheduled agricultural product has been exported, the respondent has to establish that this excess quantity has not benefited from export subsidies.

6.2.2. Domestic support

The Agreement on Agriculture establishes a rather complicated framework to reduce domestic support for agricultural products. Domestic support measures are basically categorized in three different boxes, depending on their trade-distortive potential. First, some types of support are deemed not or only minimal trade-distorting, and are therefore allowed without limits (i.e., green box support). Second, some support linked to production could also be offered if it is made in the framework of a production-limiting programme (i.e., blue box

[1918] Insofar Brazil had demonstrated the existence of such quantity in excess of the US reduction commitments. Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, above n 1912, para 14.47. This order of analysis seems to have been implicitly approved by the Appellate Body. See Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 321.

[1919] Appellate Body Report, *US – Upland Cotton*, paras 647-649.

[1920] This shift of the burden of proof might in certain cases still be relevant given that the subsidy definition is not always similar under both Agreements (e.g., list of Article 9.1 might deviate from the subsidy definition under SCM Agreement).

[1921] This result is mitigated if claims are formulated with respect to export subsidization of scheduled as well as unscheduled agricultural products. The order of analysis as specified by the compliance Panel in *US – Upland Cotton* would imply that the burden of proof is placed upon the complaining party also for the analysis under the Agreement on Agriculture. Hence, no shift in the burden of proof should take place regarding the analysis under the SCM Agreement. See Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 14.154.

support). Third, all other types of domestic support are in principle subject to reduction commitments because of their trade-distorting effect (i.e., amber box *sensu lato*). In addition to these three general boxes, two other boxes should be distinguished. First of all, all countries are allowed to offer a certain *de minimis* level of amber box support (i.e., *de minimis* box). Next, S&D treatment (so-called 'S&D box') is given to developing countries regarding some types of domestic support. Both boxes are equally exempted from reduction commitments.[1922]

6.2.2.1. Green box domestic support

Domestic support measures situated under the green box 'shall meet the fundamental requirement that they have no, or at most minimal, trade-distorting effects or effects on production'.[1923] To meet this requirement, the Agreement on Agriculture stipulates general and policy-specific criteria in Annex 2.

Two *general obligations* are established. The support must be provided through a publicly funded government programme (including government revenue foregone) not involving transfers from consumers. Moreover, it must not have the effect of providing price support to producers. In addition to these general obligations, the support programme must fit into the list of programmes provided by the Agreement on Agriculture and meet the *policy-specific criteria* in question.[1924] In broad terms, the list covers general service programmes, food security related expenditures, and decoupled direct payments to producers.

First, service programmes are government expenditures in relation to programmes which provide services or benefits to agriculture or the rural community. Examples thereof are research and training services or marketing and promotion services.[1925]

Second, food security expenditures relate to public stockholding for food security purposes as well as domestic food aid.[1926]

Third, direct payments to producers could also fall under the green box if such payments are decoupled (i.e., delinked) from various aspects of production decisions.[1927] Here, two different sets of policy-specific disciplines could be distinguished depending on the type of

[1922] The amber box *sensu stricto* could be defined as all support not covered by any of the four other boxes. Hence, it refers to all support subject to reduction commitments (see below Part II, Chapter 6, Section 6.2.2.4).
[1923] See Annex 2, para 1 of the Agreement on Agriculture.
[1924] See Annex 2, paras 2-13 of the Agreement on Agriculture.
[1925] For the specific criteria and the full list, see Annex 2, para 2 of the Agreement on Agriculture.
[1926] Annex 2, paras 3-4 of the Agreement on Agriculture.
[1927] Annex 2, paras 5-13. See also the specific criteria that should be fulfilled. See Appellate Body Report, *US – Upland Cotton*, para 321.

decoupled payments. On the one hand, decoupled income support[1928] and all non-listed types of direct payments must be decoupled from type or volume of production, domestic or international prices, and factors of production employed. Additionally, it must not require any production to receive the payment.[1929] These requirements thus aim at neutrality with regard to production decisions.[1930] The Appellate Body in *US – Upland Cotton* concurred with the Panel that a domestic support programme that includes a *negative* requirement not to produce certain crops is also not decoupled from production.[1931] After all, 'a partial exclusion of some crops from payments has the potential to channel production towards the production of crops that remain eligible for payments'.[1932] On the other hand, specific criteria are stipulated for each listed type of decoupled direct payments. These payments include income insurance and income safety-net programmes, payments for relief of natural disasters, structural adjustment assistance provided through retirement programmes or investment aid, and payments under environmental and regional assistance programmes.[1933]

If the general as well as policy-specific criteria are fulfilled, these domestic support measures qualify under the green box, implying that they are not subject to reduction commitments and may even be increased.

Notice, however, that the assumption that support measures fulfilling these 'green box' criteria are not, or only minimal, trade-distorting does not necessarily hold in practice.[1934] Indeed, as economists have pointed to, support measures that are not formally linked to (i.e., decoupled from) production decisions could still affect such decisions and thus boost production.[1935] For instance, such support could reduce fix costs, implying fewer exits by farmers, as well as make farmers less risk-averse, implying more production in a market characterized by uncertainty.[1936] Hence, the justification for such support could not be

[1928] For the definition of 'decoupled income support', see Annex 2, para 6(a) of the Agreement on Agriculture.

[1929] Annex 2, paras 5 and 6 of the Agreement on Agriculture.

[1930] Appellate Body Report, *US – Upland Cotton*, para 325.

[1931] Appellate Body Report, *US – Upland Cotton*, para 325.

[1932] Appellate Body Report, *US – Upland Cotton*, para 329.

[1933] Annex 2, paras 7-13 of the Agreement on Agriculture.

[1934] Here, trade-distortive is used in the meaning of generating production above the free trade level and thus regardless whether it is intended to correct market failures.

[1935] They indicate that the term 'decoupling' under the Agreement on Agriculture is defined in terms of policy design, whereas it is defined in terms of policy effect under the OECD (i.e., it results in a level of production and trade equal to what would have occurred if the policy were not in place). Decoupling in terms of policy design does not ensure decoupling in terms of policy effect. See H. de Gorter, M. Ingco, and L. Ignacio, 'Domestic Support: Economics and Policy Instruments', in M. Ingco and J. Nash (eds), *Agriculture and the WTO: Creating a Trading System for Development* (Washington DC: World Bank, 2004), 119-147, at 140-142.

[1936] The condition to keep the land in agricultural use could also prevent the conversion of this land into nonagricultural use. Likewise, the expectations of future payments (e.g., the existence of a system of payments for relief in case of natural disasters) might affect current output production decisions. As a final example, decoupled income support could affect investment decisions (and thus production levels) in case input market function imperfect (e.g., capital or labor market).

exclusively grounded on the assumption of no-trade effects but has to rely on specific market failures, income redistribution, or multifunctionality arguments.[1937]

6.2.2.2. Blue box domestic support

Some support that is linked to production could be offered without limitation insofar it is part of production-limiting programmes.[1938] These payments must also be based on a fixed acreage and yields or on 85 per cent or less of the base level of production. In case of livestock payments, it must be based on a fixed number of head.[1939] This 'blue box' exemption resulted from a compromise between the EC and the US during the Uruguay Round.[1940] Payments are directly linked to acreage or animal numbers but under a programme that limits production by imposing production controls in the form of quotas or acreage constraints (e.g., land set-asides).[1941] Contrary to green box measures, production is thus still required but the support does not directly relate to actual output levels. Hence, it is generally acknowledged that these subsidies are trade-distorting[1942] but the assumption is that output levels would fall over time and so would the demand for trade protection. Therefore, some Members, in particular the EC, consider blue box subsidies as a necessary first step to converting distorting subsidies into green box subsidies, whereas others, however, aim to limit or to abandon this category. There exist currently no limits on providing blue box

[1937] This raises the question whether such support is the optimal policy to reach such objectives.
[1938] This condition is not further defined.
[1939] Article 6.5(a) of the Agreement on Agriculture.
[1940] In the so-called Blair House Agreements, the US gave into the EC's insistence to create such a 'blue box' upon the condition that its principal domestic support instrument (i.e., deficiency payments) was likewise covered. Soon after the conclusion of the Uruguay Round, the US formally converted these 'blue box' subsidies into 'green box' subsidies. In 2002, the new US Farm Bill created a new type of support, namely countercyclical payments. Yet, these payments cannot benefit from the existing 'blue box' exemption because they are not made under a production-limiting programme, even though they meet the other conditions of the 'blue box'. This explains why the US proposed to redefine the 'blue box' criteria in the Doha Round. In recent years, the EC is also moving away from 'blue box' towards 'green box' measures (see below Part II, Chapter 6, Section 6.2.2.5). See McMahon, above n 1729, at 86; S. F. Olsen, 'The Negotiation of the Agreement on Agriculture', in B. O'Conner (ed), *Agriculture in WTO Law* (London: Cameron May, 2005), 43-82, at 76-77; F. Delcros, 'The Legal Status of Agriculture in the World Trade Organization', 36:2 *Journal of World Trade* (2002), 219-253, at 239.
[1941] See de Gorter, Ingco, and Ignacio, above n 1935, at 130.
[1942] Interestingly, de Gorter et al explained in 2005 how the EC blue box subsidies had the potential to distort trade. For instance, individual farmers still had an incentive to increase acreage to maximize their share of the regional payments because acreage payments were based on a fixed *regional* base. Likewise, in case of acreage constraints, production could still be distorted since farmers used inputs more intensively. Regarding headage payments for cattle, these were also not production-reducing because the number of animals eligible was not limited to numbers on farms prior to the installment of the payments in 1992. Hence, farmers had an incentive to expand their stock and to keep their level consistent with the maximum number eligible for payments. In case blue box payments are based on inframarginal levels of inputs (i.e., below the level that would be used in the case of no payments), they could still have the same trade-distorting potential as decoupled payments (green box measures) (see above n). See de Gorter, Ingco, and Ignacio, above n 1935, at 131-132, 140, 144. For an overview of the current EC blue box measures, see G/AG/N/EEC/58, 24 February 2009.

subsidies. All WTO Members could offer such support, thought it is in practice mostly deployed by developed countries.[1943]

6.2.2.3. S&D box domestic support

Developing countries are not obliged to reduce direct or indirect measures of assistance to encourage agricultural and rural development. In particular, three forms of assistance are included in this S&D box: (i) investment assistance generally available to agriculture; (ii) input subsidies generally available to low income or resource-poor producers; and (iii) support to producers to encourage diversification from growing illicit narcotic crops.[1944] Among all developing countries, India has been the main user of exempted S&D box support. This is not unexpected given that India has, contrary to some other large developing countries (e.g., Brazil, Argentina), no right to offer amber box subsidies above the *de minimis* level.[1945]

6.2.2.4. Amber box domestic support

All other subsidies are placed in the amber box *sensu lato* and are in principle subject to reduction commitments. Nonetheless, a limited amount of such trade-distortive subsidies that would normally be subject to reduction commitments can be provided (i.e., *de minimis* box).[1946] In case of product-specific subsidies, support up to 5 per cent of the value of production of the product in question can be given. In case of non-product-specific subsidies, support up to 5 per cent of the value of total agricultural production can be provided. These *de minimis* thresholds are raised to 10 per cent for developing countries, except for China which committed to a *de minimis* level of 8.5 per cent.[1947]

In conclusion, exempted domestic support measures are (i) green box subsidies; (ii) blue box subsidies; (iii) *de minimis* box subsidies; (iv) S&D box subsidies in case of developing countries. All domestic support that is not exempted is considered subject to reduction commitments (i.e., amber box *sensu stricto*).[1948] This leftover category captures product-specific subsidies as well as non-product-specific subsidies. Included product-specific subsidies are market price support, non-exempt direct payments, and other non-exempt

[1943] For a list of all nine Members (counting the EC-15 as one) that have made at least one blue box notification between 1995 and 2003, see *Note by the Secretariat, Blue Box Support* (TN/AG/S/14, 28 January 2005).
[1944] Article 6.2 of the Agreement on Agriculture.
[1945] See M. Gopinath, D. Laborde, *Implications for India of the May 2008 Draft Agricultural Modalities* (Geneva: ICTSD, July 2008), 21 pp.; A. Nassar, C. Cabral da Costa, and L. Chiodi, *Implications for Brazil of the July 2008 Draft Agricultural Modalities* (Geneva: ICTSD, 2008), 33 pp., at 9.
[1946] The amber box *sensu lato* equals the amber box *sensu stricto* added with the *de minimis* box.
[1947] Article 6.4 of the Agreement on Agriculture. *Report of the Working Party Report on the Accession of China* (WT/ACC/CHN/49), para 235.
[1948] Article 6.1 of the Agreement on Agriculture.

policies such as input subsidies or marketing cost reduction measures.[1949] For example, market price support covers the gap between the price that should be received by producers and the lower world market price and thus obviously has an impact on production decisions.

To apply reduction commitments, the exact amount of non-exempted subsidies should be quantified first. To this end, the concept of Aggregate Measurement of Support (AMS) refers to the annual support in monetary terms provided for non-exempted product-specific and non-product-specific support.[1950] For each basic agricultural product, a specific AMS is established and all non-product-specific support is totaled into one non-product-specific AMS. Subsequently, the sum of all these AMS[1951] delivers the Total AMS. This is one single figure representing the full amount of domestic subsidies subject to reduction commitments (with the Current Total AMS of year X indicating the Total AMS for year X). Importantly, reduction commitments undertaken during the Uruguay Round were made at this aggregate level. So, in contrast to export subsidies, commitments were not made at the product level, which implies that Members can maintain (and even increase) high levels of support to sensitive agricultural products. The reduction commitments were calculated on the basis of the Base Total AMS, representing the average amount of non-exempted support[1952] from 1986 through 1988.[1953] All Members with non-exempted subsidies during this period had to undertake reduction commitments.[1954] The developed countries had to reduce their Base Total AMS by 20 per cent over six years, whereas developing countries committed to a reduction of 13.3 per cent over ten years and LDCs were exempted from commitments.[1955] Yet, because of the high level of the Base Total AMS,[1956] the level of support for 1995

[1949] Annex 3 of the Agreement on Agriculture.
[1950] Article 1(a) and Annex 3 of the Agreement on Agriculture. If the calculation of the AMS is impracticable, an 'Equivalent Measurement of Support' is used (Article 1(d) and Annex 4 of the Agreement on Agriculture).
[1951] And all the 'Equivalent Measurement of Support' if this is used.
[1952] However, some exempted subsidies, such as blue box subsidies, were taken into account in the calculation of the Base Total AMS, whereas they were excluded from the Current Total AMS. The Agreement on Agriculture was not clear on this point: Article 1(a), on the calculation of the AMS, only excludes green box measures, whereas Article 6, on the subsidies subject to reductions, also excludes the other types of exempted subsidies ('set out in this article'). Including blue box subsidies clearly increased the Base Total AMS, implying that Members started from a higher benchmark.
[1953] Yet, upon insistence of the EC, 'credit *(was)* allowed in respect of actions undertaken since the year 1986' (emphasis added). If the amount of subsidies diminished over the period from 1986 through 1988, Members could thus use the higher 1986 amount of subsidies to calculate the Base Total AMS. The aim, again, was to set the amount of the Base Total AMS as high as possible. See Modalities Paper, above n 1804, para VIII.
[1954] Thirty Members (counting the EC as one) were in this situation.
[1955] Modalities Paper, above n 1804, paras VII, XV, and XVI. The reductions had to be implemented progressively, implying that a developed country had to reduce its level of AMS each year of the implementation period with roughly 3.3 per cent ('Annual Bound Commitment Level'). The Current Total AMS in a certain year could not exceed the corresponding Annual Bound Commitment Level. At the end of the 6-year period, the Base Total AMS was thus reduced by 20 per cent, resulting in the Final Bound Commitment Level.
[1956] See above n 1952 and 1953.

(Current Total AMS of 1995) of some developed countries was already close to, or even less than, their final commitment level for 2000 (Final Bound Commitment Level).[1957] Needless to say, the reduction commitments on domestic support resulting from the Uruguay Round were not far-reaching for the major subsidizing countries. This Final Bound Commitment Level, which had to be implemented by 2000 for developed countries and by 2004 for developing countries, still serves as the ceiling for non-exempted domestic support. Indeed, no new reduction commitments have been agreed upon until present.[1958] On the other hand, all WTO Members that do not have non-exempted domestic support (e.g., India, China) have to remain within the *de minimis* levels of amber box support *sensu lato*.[1959]

6.2.2.5. Conclusion and Doha Round negotiations

Under the present framework, all WTO Members are allowed to provide green box, blue box, and a *de minimis* level of amber box subsidies (i.e., *de minimis* box). In addition, developing countries are free to offer support falling under the S&D box. Finally, the largest subsidizing Members (around thirty[1960]), namely those that had non-exempted subsidies in place, are allowed to offer an additional level of amber box subsidies (i.e., amber box *sensu stricto*) corresponding to their Final Bound Total AMS.[1961]

Compared to these commitments made in the Uruguay Round, the limits set on such spending in the latest draft agreement tabled under the Doha negotiations are much more substantive.[1962] First, Members would commit to a reduction in the level of Overall Trade-Distortive Domestic Support (OTDS), composed of amber box *sensu stricto* (Final Bound Total AMS), blue box subsidies, and *de minimis* box spending. Reductions commitments would be undertaken on the basis of a tiered formula, whereby the largest cuts will have to be

[1957] For example, the EC and the US were already below their final bound level in 1995. Yet, the US increased its level of support in the subsequent years but notified these in a way that it was still in conformity with the reduction commitments. However, the *US – Upland Cotton* case has shown that this classification was not fully appropriate (e.g., some support was not accepted as green box support). See also S. Murphy and S. Suppan, 'The 2008 Farm Bill and the Doha Agenda', *IATP Commentary* (25 June 2008).
[1958] Yet, this might have to be nuanced because the levels are set in nominal terms and inflation may thus make these ceilings more constraining over time.
[1959] Article 7.2(b) of the Agreement on Agriculture.
[1960] Counting the EC-15 as one.
[1961] For instance, the EC-15 (revised) Final Bound Total AMS is €67.2 billion and the US Final Bound Total AMS is $19.1 billion.
[1962] For an assessment of the implications of (one of the latest) draft proposals on the main subsidizing countries see: S. Jean, T. Josling, and D. Laborde, *Implications for the European Union of the May 2008 Draft Agricultural Modalities* (Geneva: ICTSD, June 2008), 30 pp.; D. Blandford, D. Laborde, and W. Martin, *Implications for the United States of the May 2008 Draft Agricultural Modalities* (Geneva: ICTSD, June 2008), 25 pp.; K. Yamashita, *Implications for Japan of the July 2008 Draft Agricultural Modalities* (Geneva: ICTSD, June 2008), 24 pp..

made by those countries having the highest levels of OTDS.[1963] These reductions would be gradually implemented over five years. Developing countries would have to make lower cuts (two-third) over a longer implementation period (8 years). Moreover, exempted from reductions in OTDS are developing countries that have no Final Bound Total AMS and some recently-acceded members. Next, a similar tiered formula will be applied for specific reductions in Members' Final Bound Total AMS. Contrary to the current disciplines, also product-specific AMS levels will be set. Lastly, two other novelties are specific reductions on the (non-)product-specific *de minimis* box spending as well as on blue box payments. Here, an overall blue-box as well as product-specific blue box ceiling would be defined based on the percentage of the value of production. Regarding each of these reduction commitments, more flexibility would be offered to developing countries (S&D treatment) as well as to recently-acceded members. No reductions will have to be made on green box and S&D box support.[1964] In sum, next to further reduction commitments on total levels of amber box support, the Revised Draft Modalities for Agriculture would thus introduce product-specific reductions as well as reductions on trade-distortive subsidies in boxes that are currently exempted (*de minimis* box, blue box).[1965]

Reductions in blue box payments might become more acceptable to its principle user as the EC is converting its blue box support into green box support. To be sure, the drop in blue box support is more than compensated by an increase in green box support, resulting in a total level of notified support not seen since the last decade.[1966] The same trend is observable in the US, which soon after the Uruguay Round cancelled its blue box support but also steadily increased its green box support. As part of the 2002 Farm Bill, the US introduced countercyclical payments (i.e., support to counter price drops), though the *US – Upland Cotton* ruling rejected their qualification as green box measures.[1967] Because such payments are not made as part of a production-limiting programme, they likwewise do not qualify as blue box measures and accordingly fall under the amber box. Hence, a specific demand of the US in the Doha negotiations was a modification of the 'blue box' conditions so that these

[1963] The exact percentages are: 80 per cent (Base OTDS above $60 billion); 70 per cent (Base OTDS between $60 billion - $10 billion), 55 per cent (Base OTDS below $10 billion).
[1964] Modifications are also made to the green box measures (e.g., enlarging the types of support by developing countries that would fit in the green box).
[1965] Revised Draft Modalities for Agriculture, above n 652.
[1966] Notified blue box has dropped from €13.4 billion in the 2005/2006 marketing year to €5.7 billion in the 2006/2007 marketing year, while green box support has increased over the same period from €40.3 billion to €56.5 billion. The total level of notified support in 2006/2007 reached €90.7 billion. See *Notification* (G/AG/N/EEC/64, 4 February 2010); ICTSD, 'Total EU Farm Subsidies Grow Despite Drop in Production-Linked Payments', 14:5 *Bridges Weekly Trade News Digest* (10 February 2010).
[1967] See above n 1380, 1931, 1932.

countercyclical payments would be eligible.[1968] As a result, direct payments would under the new draft qualify as blue box measures not only if they are made under a production-limiting programme but also if no production is required at all.[1969,1970] At the same time, the overall and product-specific ceilings upon such support should prevent that this leads to a substantive increase of support under the expanded blue box. Although the general shift towards green box measures should be welcomed, the fact that such massive support might still distort trade flows is a growing concern for larger developing countries. Such green box would remain unlimited if the Revised Draft Modalities for Agriculture would be adopted.[1971] On the other hand, as will be argued in the next section, all trade-distortive agricultural support, regardless of its status under the Agreement on Agriculture, could be challenged under the SCM Agreement since the expiration of the peace clause. Notice in this respect that the Revised Draft Modalities for Agriculture does not foresee in the re-installation of the peace clause.

6.2.3. Relationship between the SCM Agreement and Agreement on Agriculture

Our discussion has clearly demonstrated that the Agreement on Agriculture is more lenient vis-à-vis export subsidies and domestic subsidies than the SCM Agreement. However, an important issue is to what extent agricultural subsidies are exempted from the stricter disciplines imposed under the SCM Agreement. The Agreement on Agriculture articulates in Article 21 that 'the provision of GATT 1994 and of other Multilateral Trade Agreements in Annex 1A to the WTO Agreement (e.g., the SCM Agreement) shall apply subject to the provisions of this Agreement'.[1972] This provision should be read together with the peace clause (Article 13 of the Agreement on Agriculture). This provision temporarily limited the applicability of the SCM Agreement for certain Agreement on Agriculture-conforming subsidies. Export subsidies in conformity with the Agreement on Agriculture disciplines could not be considered prohibited or actionable subsidies but could be countervailed, although 'due restraint' had to be shown in initiating CVDs-investigations. Regarding

[1968] This was agreed as part of the *The Doha Work Programme – Decision Adopted by the General Council on 1 August 2004* (WT/L/579, 2 August 2004). See Blandford, Laborde, and Martin, above n 1962, at 5.
[1969] This was accepted as part of the 2004 July Framework Decision. The only US concession obtained by the G-20 in return at that time was the 2.5 ceiling set upon overall blue box support. R. Aggarwal, 'Dynamics of Agriculture Negotiations in the World Trade Organization', 39:4 *Journal of World Trade* (2005), 741-761, at 755.
[1970] Under the 2008 Farm Bill, farmers can choose between the countercyclical payment (CCP) program or the newly introduced Average Crop Revenue Election program (ACRE), which is an income insurance program protecting farmers against both low yields and price drops. The US has not yet decided how it would notify ACRE under the current rules. Since the payments would be linked to current instead of historical yields under ACRE, Blandford et at tentatively suggest that they would also likely not fit into the new blue box once the Doha round is concluded. Blandford, Laborde, and Martin, above n 1962.
[1971] The conditions to fall in the green box would be somewhat modified (see above n 1964).
[1972] Article 21 of the Agreement on Agriculture.

domestic subsidies, green box subsidies could not be considered actionable subsidies and could not be countervailed. All other domestic support measures in conformity with the Agreement on Agriculture were countervailable subject to the exercise of due restraint and could not be considered actionable subsidies if the support granted to a specific commodity was not in excess of the support provided during 1992. However, this peace clause expired at the end of 2003, raising the question whether the applicability of the relevant SCM Agreement disciplines has enlarged since then. This section consecutively examines whether disciplines in Part II (prohibited subsidies), Part III (actionable subsidies), and Part V (CVDs) of the SCM Agreement are currently applicable to agricultural subsidies.

6.2.3.1 Are agricultural export subsidies and local content subsidies prohibited under the SCM Agreement?

Article 3.1 of the SCM Agreement spells out a general prohibition on local content subsidies as well as export subsidies. In the *US – Upland Cotton* dispute, the question of its applicability regarding agricultural products raised regarding both sets of subsidies.

First, it had to be decided whether subsidies contingent upon the use of domestic agricultural goods that are consistent with the domestic support provisions of the Agreement on Agriculture are nonetheless prohibited under 3.1(b) of the SCM Agreement. Obviously, this issue is highly relevant as a positive answer would imply that a measure compatible with the Agreement on Agriculture would be prohibited under the SCM Agreement.

Second, Brazil claimed that export credit support already found by the Panel to be *inconsistent* with the Agreement on Agriculture was, in addition, inconsistent with the prohibition on export subsidies (3.1(a)) of the SCM Agreement.[1973] The relevance of such an additional claim lies in the stricter implementation obligations which result from a violation of the SCM Agreement's prohibited subsidies provisions. In particular, as the Appellate Body in *US – Sugar* explained, Article 4.7 of the SCM Agreement mandates the panel to make an additional recommendation to 'withdraw the subsidy without delay' and this will become a recommendation or ruling of the DSB.[1974] The presence of this specific remedy explains why the Appellate Body instructed panels to not exercise judicial economy on claims under Article 3 of the SCM Agreement even when another WTO-violation would have already been found.[1975] Important to keep in mind, Brazil's claim under Article 3.1(a) was confined to export credit support found *inconsistent* with the Agreement on Agriculture.

[1973] See below Part III, Chapter 5, Section 5.2.

[1974] Article 4.7 of the SCM Agreement is a special rule superseding the general rule established in Article 19.1 of the DSU (Article 1.2 of the DSU stipulates the '*lex specialis derogat legi generali*' maxim). See Appellate Body Report, *EC – Export Subsidies on Sugar*, paras 329-335.

[1975] Appellate Body Report, *EC – Export Subsidies on Sugar*, para 335. This is, however, not always obeyed. Panel Report, *China – Auto Parts*, para 7.635.

Hence, Brazil did not claim that the level of export subsidies in *conformity* with the Agreement on Agriculture (i.e., to scheduled products below Member's commitment level) was inconsistent with Article 3.1(a) of the SCM Agreement.

The relationship between the Agreement on Agriculture and Article 3.1 of the SCM Agreement is governed by the introductory phrase of Article 3.1 of the SCM Agreement and Article 21.1 of the Agreement on Agriculture.

First, Article 3.1 of the SCM Agreement stipulates that '(*e*)*xcept as provided in the Agreement on Agriculture*, the following subsidies (export subsidies and import substitution subsidies), (…), shall be prohibited'.[1976] Consequently, the Agreement on Agriculture prevails over Article 3 of the SCM Agreement in the Appellate Body's reading 'but only to the extent that the former contains an *exception*'.[1977]

Second, as introduced above, Article 21.1 of the Agreement on Agriculture stipulates that other agreements on trade in goods 'shall apply subject to the provisions' of the Agreement on Agriculture. According to the panel in *US – Upland Cotton*, this implies that the Agreement on Agriculture takes precedence 'in the event, and to the extent, of any *conflict*'.[1978] In particular, the Panel distinguished three situations of such a conflict where the Agreement on Agriculture would thus prevail, namely in case (i) *an explicit carve-out or exemption* from the disciplines in the SCM Agreement existed in the text of the Agreement on Agriculture; (ii) it would be *impossible* for a Member *to comply* with its obligations under the Agreement on Agriculture and the SCM Agreement *simultaneously*; (iii) there is *an explicit authorization* in the text of the Agreement on Agriculture that would authorize a measure that, in the absence of such an express authorization, would be prohibited by the SCM Agreement.[1979] Hence, the situation articulated in Article 3.1(a) is also covered under Article 21.1 of the Agreement on Agriculture ((i) and (iii)). Although explicitly agreeing with these examples, the Appellate Body concluded that other situations could be covered by Article 21.1 as well given that this provision should be interpreted more broadly as excluding other agreements in case the Agreement on Agriculture 'contains specific provisions dealing *specifically with the same matter*'.[1980]

Applying both provisions to the query on the applicability of the prohibition on local content subsidies, the Appellate Body agreed with the Panel's conclusion that this prohibition is applicable to agricultural subsidies. After all, there is no provision in the Agreement on

[1976] Emphasis added.
[1977] Appellate Body Report, *US – Upland Cotton*, para 530.
[1978] Panel Report, *US – Upland Cotton*, para 7.1036 (emphasis added).
[1979] The Panel formulated these as examples (para 7.1038) but seemed to consider this as an exhaustive list (para 7.1039).
[1980] The Appellate Body referred to this standard articulated in *EC – Bananas III*, para 155 (as well as Appellate Body Report, *Chile – Price Band System*, para 186). Appellate Body Report, *US – Upland Cotton*, para 532 (emphasis added).

Agriculture that 'deal(s) specifically with the same matter as Article 3.1(b) of the SCM Agreement, that is, subsidies contingent upon the use of domestic over imported goods'.[1981] Accordingly, user marketing payments provided to domestic users of US upland cotton were prohibited under the SCM Agreement since they qualified as local content subsidies in the meaning of Article 1 *juncto* 3.1(b) of the SCM Agreement.[1982] Concerning the claim of the applicability of the prohibition on export subsidies (3.1(a)), the Panel in *US – Upland Cotton* concluded that agricultural export subsidies *inconsistent* with the Agreement on Agriculture are not exempted from the applicability of Article 3.1(a) by virtue of its opening clause *juncto* the peace clause.[1983] Even though the Appellate Body concurred, a consistent application of its own broad reading of Article 21.1 Agreement on Agriculture would have foreclosed the applicability of Article 3.1(a) of the SCM Agreement.[1984] Indeed, the Agreement on Agriculture does have provisions 'dealing specifically with the same matter', namely those elaborated above disciplining export subsidies (and even export credit support in particular). The Panel's more limited reading of Article 21.1, in which only *conflicting* provisions are exempted, seems more in line with the Appellate Body's own conclusion that agricultural export subsidies inconsistent with the Agreement on Agriculture could subsequently be scrutinized under Article 3 of the SCM Agreement.[1985]

Next, the original as well as compliance Panel in *US – Upland Cotton* found that the challenged agricultural export subsidies (i.e., subsidized export credit guarantees) qualified as export subsidies in the meaning of the SCM Agreement.[1986] As a result, they concluded – and the Appellate Body agreed – that, *to the extent* that these export credit guarantees were

[1981] Appellate Body Report, *US – Upland Cotton*, para 546. The US had pointed to paragraph 7 of Annex 3 and 6.3 of the Agreement on Agriculture. Notice that the peace clause did not shield subsidies away from Article 3.1(b) of the SCM Agreement.

[1982] Panel Report, *US – Upland Cotton*, para 7.1088; Appellate Body Report, *US – Upland Cotton*, para 552.

[1983] The peace clause was still applicable at the time of the original dispute. Panel Report, *US – Upland Cotton*, para 7.947. The Panel only cited Article 3.1(a) (and not Article 21.1) but also referred to its general discussion on this relationship under the part on local content subsides which included a discussion on Article 21.1 Agreement on Agriculture.

[1984] According to the Appellate Body in *US – Sugar*, one of the 'complex issues' of an additional analysis of agricultural export subsidies under Article 3 of the SCM Agreement is 'whether the Agreement on Agriculture contains "specific provisions dealing specifically with the same matter"'. Appellate Body Report, *EC – Export Subsidies on Sugar*, para 339 and footnote 537.

[1985] Appellate Body Report, *US – Upland Cotton*, paras 583-584 (footnote 858), 629-630, 674, 732.

[1986] The Panel applied the same 'export subsidy'-standard upon which it had indirectly relied under the Agreement on Agriculture (i.e., item (j) of Illustrative List) (see below Part III, Chapter 5, Section 5.1.1). Recall that the 'export subsidy'-definition might be different under both agreements. So, not all export subsidies under the Agreement on Agriculture are *ipso facto* 'export subsidies' under the SCM Agreement (e.g., the 'unusual' type of agricultural export subsidy listed in Article 9.1(c) of the Agreement on Agriculture). The difficult assessment whether an export subsidy was also present under the SCM Agreement might explain the option of the Panel in *EC – Export Subsidies on Sugar* to exercise judicial economy on the claim under Article 3.1 of the SCM Agreement, after having found an export subsidy in the meaning of Article 9.1(c) of the Agreement on Agriculture. As explained, the Appellate Body considered this false judicial economy. Panel Report, *EC – Export Subsidies on Sugar*, paras 7.381-7.384; Appellate Body Report, *EC – Export Subsidies on Sugar*, para 335.

inconsistent with the Agreement on Agriculture, they were also inconsistent with Article 3.1(a) of the SCM Agreement. Although this was not accurately formulated at the original level, the compliance Panel rightly confined its findings under the SCM Agreement to the part of the export subsidy programme inconsistent with the Agreement on Agriculture.[1987] Consequently, the US had to withdraw these export subsidies *only* to the extent that they were inconsistent with the Agreement on Agriculture (i.e., exceeded its commitment levels).[1988]

Nonetheless, the Panel at the compliance level explicitly left open whether, now that the peace clause had lapsed, 'there may be a violation of Articles 3.1(a) and 3.2 of the SCM Agreement in respect of *all* exports (i.e., even those that conform to the disciplines of the Agreement on Agriculture)'.[1989] Answering this question affirmatively, as the Cairns group and some US negotiators have suggested,[1990] would imply that agricultural export subsidies *not* exceeding a Member's commitments under the Agreement on Agriculture[1991], and thus in conformity with the Agreement on Agriculture, would nonetheless be prohibited by virtue of Article 3.1 of the SCM Agreement.[1992] The pivotal issue here is whether the introductory phrase of Article 3.1 of the SCM Agreement and/or Article 21.1 of the Agreement on Agriculture shields such agricultural export subsidies from the applicability of Article 3.1 of the SCM Agreement even after the *explicit exception* stipulated in the peace clause (Article 13 of the Agreement on Agriculture) has lapsed.[1993]

Whereas the case law did not offer a decisive answer as of yet, some elements suggest that WTO-adjudicating bodies will still exempt such agricultural export subsidies from the prohibition of Article 3.1 of the SCM Agreement. First, albeit dating from before the expiration of the peace clause, the Appellate Body in *Canada – Milk/Dairy Article 21.5* concluded that the WTO-consistency of an export subsidy should be examined, in the first place, under the Agreement on Agriculture and, importantly, it based this conclusion on the introductory phrase of Article 3.1 of the SCM Agreement. This conclusion was merely

[1987] See below Part III, Chapter 5, Section 5.2.
[1988] This was also taken into account by the Arbitrator for the calculation of the appropriate amount of countermeasures. Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, para 4.207. See above Part II, Chapter 5, Section 5.1.3.2.2.
[1989] This claim was not formulated by Brazil. Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, footnote 785.
[1990] Implicit in their reasoning is that the phrase 'except as provided in the Agreement on Agriculture' merely refers to the peace clause. According to the Cairns Group, agricultural export subsidies are no longer saved from scrutiny under Article 3 of the SCM Agreement since the expiration of the peace clause. See *Cairns Group Negotiating Proposal, Export Competition* (G/AG/NG/W/11, 16 June 2000). The US negotiators position could likely be explained in light of the much higher level of direct export subsidies provided by the EC. See Steinberg and Josling, above n 1153, at 377.
[1991] This could relate to listed or non-listed export subsidies to agricultural products within Members' reduction commitments or, in case of developing countries, to marketing and transport export subsidies.
[1992] Of course, this only holds insofar they qualify as export subsidies within the meaning of the SCM Agreement.
[1993] Article 13(c)(ii) of the Agreement on Agriculture.

'borne out', in other words, confirmed/supported by – and not dependent on – the peace clause.[1994] Second, the Panel in *US – Upland Cotton* observed that the quantitative limits imposed by the export subsidy disciplines of the Agreement on Agriculture 'may be considered less stringent than the outright prohibition on export subsidies found in Article 3.1(a) of the SCM Agreement (but) these less stringent obligations are *explicitly spelled out in the text of the Agreement*, with further *guidance* provided in Articles 13 and 21 of the Agreement'.[1995] The indication that the text of the Agreement on Agriculture 'explicitly spells out' more flexible rules seems to fit surprisingly well with the same Panel's interpretation that, by virtue of Article 21.1, the Agreement on Agriculture would prevail in a situation where 'there is *an explicit authorization* in the text of the Agreement on Agriculture that would authorize a measure that, in the absence of such an express authorization, would be *prohibited* by the SCM Agreement'.[1996] Although the Panel did not indicate which provision(s) it exactly had in mind, a prime candidate may be Article 8 of the Agreement on Agriculture, which stipulates that Members undertake 'not to provide export subsidies *otherwise than in conformity with*' the Agreement on Agriculture.[1997] This provision indeed seems to serve as an 'explicit authorization' for agricultural export subsidies under Article 21.1 of the Agreement on Agriculture and an (implicit) 'exception' under the introductory clause of Article 3.1 of the SCM Agreement from the *prohibition* on export subsidies.[1998] Most authors tend to agree with the conclusion that, even after the expiration of the peace clause, agricultural export subsidies in conformity with the Agreement on Agriculture are not prohibited under the SCM Agreement.[1999] We now turn to the issue whether such export

[1994] 'The relationship between the Agreement on Agriculture and the SCM Agreement is defined, in part, by Article 3.1 of the SCM Agreement, which states that certain subsidies are "prohibited" except as provided in the Agreement on Agriculture. This clause, therefore, indicates that the WTO consistency of an export subsidy for agricultural products has to be examined, in the first place, under the Agreement on Agriculture. This is *borne out* by Article 13 (c) (ii) of the Agreement on Agriculture (…)' (emphasis added). Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US),* paras 123–124.

[1995] This was contrasted with the absence of any indication of the drafters' intention to exempt agricultural subsidies from the local content subsidy prohibition. Panel Report, *US – Upland Cotton*, para 7.1074 and footnote 1216 (emphasis added). Again, Article 13 Agreement on Agriculture is only considered further 'guidance'.

[1996] Panel Report, *US – Upland Cotton*, para 7.1038 (emphasis added).

[1997] Emphasis added.

[1998] The argument that the broad formulation in the introductory phrase of Article 3.1 does not exclusively refer to the peace clause also finds contextual support in Article 5 of the SCM Agreement as this provision's reference is explicitly confined to the peace clause (see also below).

[1999] See, for example, Desta, above n 632, at 294; Steinberg and Josling, above n 1153, at 377, H. N. Siuves, 'The Expiry of the Peace Clause on Agricultural Export Subsidies – the Outlook Post-Cancun', 31:1 *Legal Issues of Economic Integration* (2004), 25-42, at 31-33. McNiel has taken the opposite view without, however, underpinning its argumentation. D. McNiel, 'Furthering the Reforms of Agricultural Policies in the Millennium Round', 9:41 *Minnesota Journal of Global Trade* (2000), 41-86, at 72.

subsidies as well as domestic subsidies in conformity with the Agreement on Agriculture could nonetheless be challenged as an 'actionable subsidy' (Part III of the SCM Agreement).

6.2.3.2. Are agricultural subsidies actionable under the SCM Agreement?

6.2.3.2.1. Agricultural domestic subsidies

Although some authors[2000] and diplomats seem to hold the opposite view[2001], there are strong arguments that agricultural domestic subsidies in conformity with the Agreement on Agriculture are challengeable under Part III of the SCM Agreement since the expiration of the peace clause.[2002] First, in contrast to the introductory clause of Article 3 of the SCM Agreement (prohibited subsidies), Part III of the SCM Agreement explicitly exempts from its scope 'subsidies on agricultural products *as provided in Article 13* (peace clause) of the Agreement on Agriculture'. By its terms, the exemption depends on the existence of the peace clause.[2003] This difference in reference to the Agreement on Agriculture should be given meaning. Second, the opposite reading that domestic subsidies could even in the absence of the peace clause still not be challengeable, would go against the principle of effective treaty interpretation. It would have rendered the meaning of whole clauses to 'inutility' (e.g., peace clause, Article 6.9 of the SCM Agreement, the opening clause of Article 5 of the SCM Agreement).[2004] Third and related to the previous argument, domestic

[2000] Desta, for instance, reasoned that:

> '(…) as long as countries do not respect their (Agreement on Agriculture) obligations, the Peace Clause affords them absolutely no protection whatsoever. Moreover, to the extent countries respect their obligations under the (Agreement on Agriculture), their measures remain secure from challenges based on other agreements. And, in my view, this is true regardless whether the Peace Clause expires. The only exception to this is the protection provided by the Peace Clause against claims of non-violation nullification and impairment. Apart from this, I am of the view that the role of the Peace Clause has always been more political rather than legal and, strictly speaking, the expiry of the Peace Clause could not make much legal difference'.

Desta, 'The Integration of Agriculture in WTO Disciplines', above n 1815, at 40.

[2001] Reference is in particular made to US and EC diplomats. As Chambovey explains (but does not necessarily seem to share), this interpretation would be partly based on the *lex specialis* principle. The more specific Agreement on Agriculture would prevail on the more general SCM Agreement (and GATT 1994). The object and purpose of the Agreement on Agriculture is 'to create a distinct legal regime, tailor made for agricultural products, and the general rule (the SCM Agreement) simply does not suit the particular conditions of agriculture'. D. Chambovey, 'How the Expiry of the Peace Clause (Article 13 of the WTO Agreement on Agriculture) Might alter Disciplines on Agricultural Subsidies in the WTO Framework', 36:2 *Journal of World Trade* 305 (2002), 305-352, at 309-311; Steinberg and Josling, above n 1153, at 375.

[2002] Notice that the peace clause did not shield agricultural domestic subsidies *not* in conformity with the Agreement on Agriculture from a challenge under the SCM Agreement.

[2003] Article 6.9 of the SCM Agreement stipulates that the provision on 'serious prejudice' 'does not apply to subsidies maintained on agricultural products *as provided in Article 13 of the Agreement on Agriculture*' (emphasis added).

[2004] To recall the words of the Appellate Body, '(a)n interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility'. Appellate Body Report, *US – Gasoline*, at 23. Desta's reasoning of Desta that the meaning of the peace clause is rather political than legal would be hard to reconcile with this principle (see above n 2000).

support not covered under the green box (but in conformity with the Agreement on Agriculture under one of the other boxes) was only under certain specific conditions exempted from challenges under Part III of the SCM Agreement by virtue of the peace clause. Indeed, such support to a specific commodity was not exempted if granted 'in excess of that decided during the 1992 marketing year'.[2005] If such non-green box support would still be exempted, what about the application of this condition now that the peace clause has expired?[2006] Fourth, in absence of the peace clause, only Article 21.1 of the Agreement on Agriculture could be advanced as legal basis to exempt agricultural domestic subsidies from the actionable subsidy claims under the SCM Agreement. Yet, domestic support disciplines under the Agreement on Agriculture do not 'deal specially with the same matter'.[2007] The Agreement on Agriculture sets general, non-product-specific reduction commitments on domestic support based on their alleged trade-distortive effect (by putting support into different boxes), whereas Part III of the SCM Agreement offers the opportunity to challenge specific subsidies in case they cause adverse effects.[2008,2009] Given that actionable subsidy claims depend on the demonstration of adverse effects, the provisions and negotiations under the Agreement on Agriculture regarding domestic support reduction would not be rendered to 'inutility' in case the SCM Agreement is applied. These could be seen as different tracks to cut back agricultural domestic subsidies. Fifth and finally, panels and the Appellate Body in the *US – Upland Cotton* seem to have implicitly confirmed that agricultural domestic subsidies are challengeable under Part III of the SCM Agreement. When the peace clause was still applicable (i.e., original level), they exclusively relied on this clause to determine whether an actionable subsidy claim could be formulated under the SCM Agreement. For instance, the Appellate Body, after citing the relevant part of the peace clause, interpreted that:

2005 Article 13(b)(ii) of the Agreement on Agriculture.

2006 Would this lead to the illogical conclusion that such support is now exempted *as such*, and thus that 'peace clause' period would have been more stringent than the post-peace clause period.

2007 Recall also that Article 21.1 of the Agreement on Agriculture, which according to the Appellate Body would thus preclude the application of other provisions dealing 'specially with the same matter', does *not* preclude scrutinizing export subsidies not in conformity with the Agreement on Agriculture under the export subsidy disciplines of the SCM Agreement.

2008 Nielsen also rejects that conditions on green box subsidies (Annex II) and Part III of the SCM Agreement deal with the same matter simply because they would both address the effects of subsidies (in case of green box subsidies, the conditions aim at ensuring that they are not, or minimally, trade-distorting). She underscores that the provisions in Part III of the SCM Agreement are much more elaborated. Nielsen therefore concludes that panels and the Appellate Body would likely decide that Part III of the SCM Agreement would be applicable to green box measures. L. Nielsen, 'Green Farm Subsidies Sponsoring Eco Labeling: Is the Separation of Market Access and Subsidies Regulation in WTO Law Sustainable?', 43:6 *Journal of World Trade* (2009),1193-1222, at 1219.

2009 The different implementation standards under the Agreement on Agriculture and the SCM Agreement (i.e., Article 7 of the SCM Agreement on 'actionable' subsidy claims) might also suggest that they do not specifically deal with the same matter.

> Accordingly, domestic support that conforms fully to the provisions of Annex 2—that is "green box" support, which is exempt from the domestic support reduction obligations of the Agreement on Agriculture—is also exempt, *during the implementation period*, from actions based on Article XVI of GATT 1994 and the actionable subsidies provisions of Part III of the SCM Agreement.[2010]

Because the domestic support challenged by Brazil did not meet the conditions of the peace clause, it was already actionable under Articles 5 and 6 of the SCM Agreement.[2011] Moreover, at the compliance level, when the peace clause had lapsed, the domestic support challenged by Brazil was directly scrutinized by the Panel under Articles 5 and 6 of the SCM Agreement.[2012] In sum, now that the peace clause has lapsed, there seems to be no ground to exempt domestic agricultural support from scrutiny under the SCM Agreement. Of course, to be successful, it must be demonstrated that such support is a specific subsidy causing adverse effects in the meaning of the SCM Agreement.[2013]

6.2.3.2.2. Agricultural export subsidies

We previously concluded that agricultural export subsidies *in conformity with* the Agreement on Agriculture would arguably not be *prohibited* under the SCM Agreement. Solid arguments could be advanced to infer that such support is nonetheless *actionable* under Part III of the SCM Agreement.[2014] First, assuming that agricultural domestic subsidies would indeed be challengeable as actionable subsidy, it would contradict the central approach taken in the GATT/WTO to discipline export subsidies more stringently than domestic subsidies if it is decided to exempt, at the same time, agricultural export subsidies from such potential scrutiny. Second, the only provision that could potentially be invoked to exempt agricultural export support from such challenge under Part III of the SCM Agreement is again Article 21.1 of the Agreement on Agriculture. But even in its broad reading offered by the Appellate Body, Article 21.1 of the Agreement on Agriculture does not shield agricultural export subsidies from an actionable subsidy claim given that no provision in the Agreement on Agriculture 'deals specifically with the same matter', namely with the demonstration of adverse effects of export subsidies to other Members. Third and finally, considering

2010 Appellate Body Report, *US – Upland Cotton*, para 316 (original footnote, which specified the implementation period, deleted; emphasis added). See also Appellate Body Report, *US – Upland Cotton*, para 394; Panel Report, *US – Upland Cotton*, para 7.608; Panel Report, *Mexico – Olive Oil*, para 7.68.

2011 Panel Report, *US – Upland Cotton*, paras 7.608, 7.1107; Appellate Body Report, *US – Upland Cotton*, para 394.

2012 Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 10.4. The compliance panel was well aware that the peace clause had lapsed (see above n 1989).

2013 See, for example, Panel Report, *US – Upland Cotton*, paras 7.1109-7.110.

2014 For the same reasons, agricultural export subsidies *not* in conformity with the Agreement on Agriculture could not only be challenged as prohibited subsidy under the SCM Agreement but also as actionable subsidy under Part III. This is parallel to the treatment of non-agricultural export subsidies (see Panel Report, *Korea – Commercial Vessels*, para 7.334).

agricultural export subsidies under certain circumstances consistent with the Agreement on Agriculture (e.g., if fulfilling export subsidy commitments; see above) but, at the same time, scrutinizing their trade effects under the 'actionable' subsidy category, is parallel to the treatment of certain non-agricultural export subsidies that are not prohibited by virtue of the Illustrative List. Indeed, some non-agricultural export subsidies are not prohibited on the basis of an exception spelled out in the Illustrative List, but these export subsidies are still actionable under Article 5 of the SCM Agreement.[2015] In fact, there is no conflict between considering certain (non-)agricultural subsidies as not prohibited at face value but mandating, at the same time, that their adverse effects, if demonstrated, should be taken away. The export subsidy commitment provisions under the Agreement on Agriculture can thus perfectly be applied alongside the actionable subsidy provisions of the SCM Agreement.[2016]

In sum, agricultural export subsidies conforming to the Agreement on Agriculture are challengeable under the SCM Agreement. Of course, such a claim will only be successful if it could be demonstrated that such agricultural export subsidies fall within the subsidy definition of Article 1 of the SCM Agreement and cause adverse effects (Article 5 of the SCM Agreement).

6.2.3.3. Are agricultural subsidies countervailable?

The peace clause no more than partially narrowed this unilateral venue. CVDs action was only foreclosed for 'green box' support, whereas all other types of domestic support could be countervailed subject to the additional procedural requirement to exercise 'due restraint'.[2017] With the end of the peace clause, these limitations also expired.[2018] Indeed, no element in either the SCM Agreement or Agreement on Agriculture points in the opposite direction. Since CVDs action is not spelled out under the Agreement on Agriculture, there is no provision 'specifically dealing with the same matter' in this agreement. Accordingly, Article 21.1 of the Agreement on Agriculture does not exempt agricultural subsidies from CVDs action. The Panel in *Mexico – Olive Oil* confirmed that CVDs could indeed be installed on agricultural imports.[2019]

[2015] See above Part II, Chapter 4, Section 4.1.1.3. Observe also that the peace clause explicitly exempted agricultural export subsidies from Article 5 of the SCM Agreement (Article 13(c)(ii) of the Agreement on Agriculture). Members were thus well aware that export subsidies could potentially be challenged under the actionable subsidy category.

[2016] See also Steinberg and Josling, above n 1153, at 377–378; Siuves, above n 1999, at 32–34.

[2017] Regarding the interpretation of this term, see Panel Report, *Mexico – Olive Oil*, para 7.67.

[2018] This could also be an extra argument why actionable subsidy claims, at least those under Article 5(a) of the SCM Agreement, should also be allowed because this is the multilateral variant to respond to subsidies causing injury to the domestic industry.

[2019] Because the peace clause was still in place at the moment the challenged CVDs investigation was launched, the Panel scrutinized whether Mexico had exercised 'due restraint'. The Panel did not explicitly decide that it had to scrutinize this obligation. Because Mexico had conducted its

6.2.3.4. Conclusion

This concluding section summarizes the applicability of the SCM Agreement regarding agricultural subsidies. Three types of agricultural subsidies have been distinguished: export subsidies, local content subsidies, and other domestic subsidies.

First, regarding agricultural export subsidies, a distinction is made on the application of the SCM Agreement depending on whether they conform to the Agreement on Agriculture. On the one hand, export subsidies in *conformity* with the disciplines elaborated under the Agreement on Agriculture seem also exempted from the SCM Agreement's prohibition on export subsidies. This holds for export subsidies to scheduled products within reduction commitments and for marketing or transport export subsidies offered by developing countries.[2020] Yet, these export subsidies could be challenged under the actionable subsidy provisions of the SCM Agreement and be vulnerable to CVDs action. On the one hand, export subsidies *inconsistent* with the Agreement on Agriculture are likewise prohibited under the SCM Agreement. All export subsidies for unscheduled agricultural products and for scheduled agricultural products above reduction commitments are inconsistent with the Agreement on Agriculture. These export subsidies are in addition prohibited under Article 3.1 of the SCM Agreement insofar they are captured under the export subsidy definition of the SCM Agreement (Article 1 *juncto* 3 of the SCM Agreement or the Illustrative List).[2021] Accordingly, these export subsidies should, to the extent they are inconsistent with the Agreement on Agriculture, be withdrawn without delay pursuant to Article 4.7 of the SCM Agreement.[2022]

Second, the Appellate Body confirmed in *US – Upland Cotton* that subsidies contingent upon the use of domestic agricultural products are prohibited under Article 3.1 of the SCM Agreement, regardless whether such support conforms to the Agreement on Agriculture.

Third, domestic agricultural support, regardless in which box it is located under the Agreement on Agriculture, seems actionable as well as countervailable under the SCM

investigation as if Article 13(b) of the Agreement on Agriculture was applicable, it proceeded 'on the basis of the same assumption, *arguendo*, for the purposes of this dispute'. Panel Report, *Mexico – Olive Oil*, para 7.59.

[2020] This is based on Article 27.7 of the SCM Agreement in case of an actionable subsidy claim against developing countries benefiting from S&D treatment on export subsidies under the SCM Agreement.

[2021] An exception should arguably be made for non-listed types of export subsides that merely cause a 'threat of circumvention' (Article 10.1 of the Agreement on Agriculture).

[2022] Only export subsidies offered by developing countries benefiting from S&D treatment on the prohibition of Article 3.1(a) of the SCM Agreement are exempted from the application of this provision (see above Part II, Chapter 6, Section 6.1.1). Given that these developing countries do not have scheduled agricultural products, they are not allowed to offer agricultural export subsidies (except for Article 9.4 export subsidies) under the Agreement on Agriculture. Because such support is thus inconsistent with the Agreement on Agriculture regardless of its adverse trade effects, the potential additional claim that such support is actionable pursuant to Article 27.7 of the SCM Agreement seems not relevant in practice.

Agreement. In case the multilateral track is used, it has to be demonstrated that such support measures qualify as specific subsidies under Articles 1 and 2 of the SCM Agreement as well as that they cause adverse effects. If the unilateral track is pursued, the CVDs-investigating authority has to show that specific subsidies cause injury to its domestic industry.[2023]

[2023] Recall also the S&D treatment provisions on actionable subsidy claims and CVDs actions against developing countries (Article 27.9 and 27.10 of the SCM Agreement).

PART III

CASE STUDY: WTO DISCIPLINES ON EXPORT CREDIT SUPPORT

INTRODUCTION

WTO Director-General Pascal Lamy has summed up a threefold role of the WTO in the field of trade finance: encouraging liberalization of this type of financial services, being a regulator of export credit support under the SCM Agreement, and serving as a forum to discuss WTO-compatible ways of providing support to developing countries. Regarding government involvement in trade financing, the WTO thus acts as a regulator as well as an advocate of official support for export credits. Under the Aid-for-Trade umbrella, initiatives to scale up WTO-compatible trade finance instruments in developing countries are indeed high on the agenda and WTO Members are called to deliver more export credit support for trade to WTO Members that need it most.[2024]

Soon after the outbreak of the financial crisis, Lamy also urged governments to support their export credit agencies and international financial institutions in filling the gap in trade financing caused by 'one of the most severe financial crises in modern history'.[2025] This call was responded to in April 2009 by the G-20 of developed and emerging developing countries, who promised 'to ensure availability of at least $250 billion over the next two years to support trade finance through export credit and investment agencies and through the Multilateral Development Banks'.[2026] This pledge was welcomed by OECD members and a number of other countries, as well as by international institutions such as the WTO, the IMF, and the World Bank. At the same time, these governments and international institutions emphasized 'that any measures be in place until market conditions recover and should be consistent with their respective international obligations (…)'.[2027] Yet, it will be demonstrated that reconciling both aspects is far from evident in light of existing WTO obligations.

To this end, this Part will review and evaluate the policy space the WTO effectively grants its Members to support export credits for industrial and agricultural goods as well as for services.

Before systematically assessing export credit support under the WTO framework, the concept of 'export credit (support)' and the economic rationale for such support are introduced (Chapter 1). Further, the origins of the current obligations are traced (Chapter 2). Given that an exception exists for export credit practices to non-agricultural products that are in conformity with the interest rate provisions of the OECD Arrangement on Officially

[2024] M. Auboin, 'Boosting Trade Finance in Developing Countries: What Link with the WTO?', *WTO Staff Working Paper* (November 2007), 21 pp., at 2.
[2025] WTO, *Lamy warns trade finance situation "deteriorating"* (12 November 2008). Available at: http://www.wto.org/english/news_e/news08_e/gc_dg_stat_12nov08_e.htm.
[2026] G-20, *The Global Plan for Recovery and Reform* (2 April 2009).
[2027] OECD, Working Party on Export Credits and Credit Guarantees, *Statement: The Global Financial Crisis and Export Credits* (TAD/ECG(2009)3, 23 April 2009).

Supported Export Credits (OECD Arrangement), a preliminary overview of the latest version of this arrangement is considered useful (Chapter 3).[2028] This leads to the parallel legal assessment of present WTO disciplines on industrial (Chapter 4) and agricultural products (Chapter 5). Here, the relevant regulatory framework for industrial goods is delineated in the SCM Agreement and should be complemented with the Agreement on Agriculture in case of export credit support for agricultural products. This legal framework is further clarified – one might even argue 'completed' – by several panels and the Appellate Body. To close the legal analysis, it is briefly examined whether the GATS imposes relevant restrictions on those aspects of export credit support affecting trade in services (Chapter 6). Following this legal analysis, the discussion turns to the proposals tabled in the Doha Round regarding export credit support disciplines on industrial and agricultural products (Chapter 7). Finally, a normative assessment of WTO members' policy space for trade financing will be conducted (Chapter 8).

[2028] As the *US – Upland Cotton* case has shown, these disciplines might also be relevant for determining whether export credit support for agricultural products is made at subsidized terms. Therefore, the OECD Arrangement is discussed before focusing on existing WTO disciplines on non-agricultural and agricultural products, respectively.

1. EXPORT CREDIT SUPPORT

1.1. DEFINITION

International trade transactions bear risks and require financing. Between 80 and 90 per cent of these transactions therefore rely on some sort of credit, guarantee, or insurance which provide finance or risk cover.[2029] Hence, trade finance – an umbrella term covering all sorts of financial instruments or services enabling or facilitating export and import transactions[2030] – is considered 'the lifeblood of trade' and export credits take an important share thereof. [2031]

However, neither the WTO agreements nor the OECD Arrangement defines export credits, which seem to bear somewhat 'different meanings in different contexts'.[2032] In the context of the SCM Agreement, the Panel in *Korea – Commercial Vessels* defined them as credits provided to foreign buyers.[2033] Parallel, an instrument will only constitute an export credit guarantee (or insurance) under the SCM Agreement if it guarantees (or insures) an export credit and thus covers default by a foreign buyer in respect of an export credit provided to that foreign buyer.[2034] In contrast, loans provided to the exporter, rather than to the foreign buyer, are not considered export credits under the SCM Agreement.[2035,2036]

Accordingly, export credits are credits provided to the foreign buyer. Depending on who provides such credit, it can take two forms. First, the credit can be extended directly by an

[2029] See Auboin, above n 2024, at 1.
[2030] There is also no agreed definition of the concept of 'trade finance'. For an overview of trade finance instruments, see M. Auboin and M. Meier-Ewert, *Improving the Availability of Trade Finance during Financial Crises* (Geneva: WTO Publications, 2003), 18 pp., at 2-3.
[2031] See Auboin, above n 2024, at 1; M. Auboin, 'Restoring Trade Finance During a Period of Financial Crisis: Stock-taking of Recent Initiatives', *WTO Staff Working Paper* (December 2009), 24 pp., at 4.
[2032] See J-Y. Wang, M. Mansilla, Y. Kikuchi, and S. Choudhury, *Officially Supported Export Credits in a Changing World* (Washington DC: International Monetary Fund, 2005), 55 pp., at 44.
[2033] Panel Report, *Korea – Commercial Vessels*, paras 7.316-7.323. The OECD Export Credits Secretariat considers insurance and guarantees as export credits, whereas the Panel seems to restrict this concept to credits provided to the foreign buyer (see also below n 2042). The reasoning of the Panel is in line with the separate treatment of 'export credit guarantee or insurance programmes' and 'export credits' in the Illustrative List and fits the distinction between 'export credit' and 'export credit support'. OECD, Export Credits Secretariat, *The Export Credits Arrangement 1978-2008, Achievements and Challenges Continued!* (Paris: OECD, April 2008).
[2034] The Panel referred to an instrument that 'covers default by a *borrower* in respect of an export credit provided to that *borrower*' (emphasis added). Borrowers could be interpreted as foreign buyers given that the same Panel held that export credits are loans provided to foreign buyers. Panel Report, *Korea – Commercial Vessels*, para 7.213.
[2035] Yet, they might be considered as support for export credits if they effectively support the loan to the foreign borrower (see below). Panel Report, *Korea – Commercial Vessels*, para 7.324.
[2036] The so-called pre-shipment credits, which are credits to the exporter to purchase raw materials and other inputs, were thus not considered export credits in the meaning of the SCM Agreement. Panel Report, *Korea – Commercial Vessels*, paras 7.324-7.329.

exporter to a foreign buyer in the form of deferral of payment (supplier credit).[2037] The exporter might (re)finance this export credit by a loan from its bank or export credit agency. Second, export credits might be provided by an exporter's bank or other financial institutions (or export credit agency) as loans to the buyer (or his bank) by which the buyer can pay the exporter (buyer credit). Export credits thus enable a foreign buyer to defer payment to the exporter or financial institution.[2038] Based on their maturity, export credits are often categorized into short-term (maximum one year), medium-term (between one and five years), and long-term credits (more than five years).[2039] The short-term credits are usually extended for consumer goods, spare parts and raw materials whereas the other maturities are in place for capital goods and large projects.[2040] Obviously, the terms of a loan agreement a foreign buyer can obtain forms an important factor in its choice among different exporters.

This is where an export credit agency (ECA) comes into play, by providing support to its exporters in the export credits the latter can arrange for foreign buyers. As illuminated by the scope of the OECD Arrangement, such 'official support' for export credits might take two forms. First, under 'pure cover support', which is the most common type of support, ECAs offer insurance or guarantees for export credits extended by the exporter or a financial institution to a foreign buyer (or its bank).[2041] Because under pure cover support ECAs only 'guarantee or insure' export credits that are offered by exporters or financial institutions, ECAs themselves are not extending the export credit.[2042] Second, some ECAs also offer 'official financing support' in the form of export credits (direct credit) by directly extending loans to foreign buyers to purchase specific products/services originating from the ECAs country. Other types of 'official financing support' consist of interest rate support for export credits and refinancing of export credits extended by exporters or financial institutions.[2043][2044] Export credit support for agricultural goods usually takes the form of pure cover support for short-term export credits, whereas such official support for non-agricultural products is mostly medium or long-term in nature. Some ECAs only offer medium- and long-term pure

[2037] The Panel in *Korea – Commercial Vessels* decided that 'deferral' should be understood as post-shipment deferral of payment. Panel Report, *Korea – Commercial Vessels*, para 7.326.
[2038] See Wang, Mansilla, Kikuchi, and Choudhury, above n 2032, at 5.
[2039] See Wang, Mansilla, Kikuchi, and Choudhury, above n 2032, at 5.
[2040] See Wang, Mansilla, Kikuchi, and Choudhury, above n 2032, at 5.
[2041] Article 5 of the OECD Arrangement; Item (i) of 'Annex XI – List of definitions' of the OECD Arrangement.
[2042] Panel Report, *Korea – Commercial Vessels*, paras 7.213-7.215.
[2043] Interest rate support broadly relates to 'official support for (…) the interest rate to be paid in connection with export credits'. Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, para 5.132; See also item f of 'Annex XI – List of definitions' of the OECD Arrangement.
[2044] In case of refinancing, the ECA refinances the export credits offered by their exporters or financial institutions. Strictly speaking, an export credit is thus confined to loans provided to foreign buyers, but support for such export credits might take the form of loans to exporters or financial institutions.

cover support, whereas others provide all types of export credit support (e.g., direct financing support) and cover all types of maturities.[2045] In the medium- and long-term segment, pure cover support has clearly been dominant over the last decade.[2046]

1.2. RATIONALES FOR AND PROVISION OF EXPORT CREDIT SUPPORT TO NON-AGRICULTURAL PRODUCTS

By providing these forms of support, ECAs aim at improving the financing package which exporters can offer to a potential foreign buyer and hereby improve their chances of securing the contract. The effect of an export credit on importers' decision is determined on the basis of the subsidy rate of this credit, capturing its cost-reducing effect.[2047] Hence, a common objective of ECAs is the promotion of national exports.[2048] For example, the mission of the US Export-Import Bank (Ex-Im Bank) is 'turning export opportunities into actual sales that help US companies of all sizes to create and maintain jobs in the US'.[2049] The trade-distorting potential of such support is thus apparent. As the Panel in *Canada – Aircraft (Article 21.5 – Brazil)* observed, 'among the various forms of export subsidies, subsidized export credits arguably have the most immediate and thus greatest potential to distort trade flows'.[2050] In the absence of market failures, export credit support at subsidized terms could in principle not be justified as it distorts trade and therefore depresses world welfare.

Nonetheless, promotion of national exports by export credit support is generally legitimized by ECAs on two grounds.[2051] First, it is deemed essential to counter export credit support by other governments and thus to allow national exporters to compete on an equal footing with foreign exporters (self-defence instrument).[2052] This explains, for instance, why the US Ex-Im Bank annually presents the US Congress a report on the competitiveness of its support vis-

[2045] See Export-Import Bank of the United States, *Report to the US Congress on Export Credit Competition and the Export-Import Bank of the United States* (June 2009), 139 pp., at 93.
[2046] It accounted for over 80% of G-7 ECAs' medium- and long-term activity. Since the outbreak of the financial and economic crisis, the call for direct credit has increased again. Export-Import Bank of the United States, above n 2045, at 94-95.
[2047] Formally, the subsidy rate is the per cent by which the export credit reduces the present value of the trade commodity.
[2048] Moser et al have demonstrated that ECAs indeed have an export-promoting effect. See C. Moser, T. Nestmann, and M. Wedow, 'Political Risk and Export Promotion: Evidence from Germany', 31:6 *World Economy* (2008), 781-803.
[2049] See Export-Import Bank of the US, 'Annual Report 2007 – Mission Statement'. Available at: http://www.exim.gov/about/reports/ar/ar2007/Index_IR.html.
[2050] Panel Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para 5.137
[2051] J. E. Ray, *Managing Official Export Credits – The Quest for a Global Approach* (Washington DC: Institute for International Economics, 1995) 322 pp., at 8; D. C. Zehner, 'An Assessment of Two Economic Rationales for Export Credit Agencies', *Chazen Web Journal of International Business* (Spring 2003), 1-11; Wang, Mansilla, Kikuchi, and Choudhury, above n 2032, at 20.
[2052] Pursuant to the US Ex-Im Bank's Mission Statement: 'Ex-Im Bank also helps US exporters remain competitive by countering the export financing provided by foreign governments (…)'.

à-vis other ECAs of G-7 countries.[2053] Obviously, this rationale on itself would suggest that countries would better cooperate to impede such export support competition. Second, it is legitimized by reference to market failures in the private trade finance sector.[2054] Many ECAs, such as the US Ex-Im Bank, are for that matter explicitly prohibited to compete with the private sector.[2055] As a result, ECAs offer support for export transactions that would not or not at affordable prices be offered by the private sector, because the private capital market lacks sufficient information to properly assess the risks of the transaction (asymmetry of information).[2056] By relying, for example, on official bilateral channels, governments would be better placed to gather information needed to assess transaction risks (in particular country risk).[2057] The large size of the transaction might also hamper private sector trade finance.[2058] This information/capacity market failure argument assumes that private financial institutions only lack sufficient information and capacity to offer trade finance without government support. The trade finance conditions set by ECAs could be considered commercially sound but the private finance market fails to seize this opportunity.[2059] If an ECA purely operates on the basis of this rationale, its functioning should not entail any cost to the government. Partly, this can be ensured by the requirement to be self-sustaining imposed on many ECAs.[2060]

This information/capacity-market failure argument situated in the capital market should be distinguished from other, often implicit, rationales for official export credits which correspond to general arguments in favour of export-promoting instruments. First, as explained in Part I, an ECA might offer support because of positive spillovers deemed to be attached to exports (e.g., technology spillovers, or reputation in foreign markets) or such

2053 See, for example, Export-Import Bank of the United States, above n 2045, at 13-14.

2054 According to the US Ex-Im Bank's Mission Statement, it 'assumes the credit and country risks that the private sector is unable or unwilling to accept'. See, for example, K.W. Dam, *The GATT – Law and International Economic Organization* (Chicago: The University of Chicago Press, 1970), 480 pp., at 139.

2055 See, for example, Export-Import Bank of the United States, above n 2045, at 13-14.

2056 Among the potential risks are those linked to the importer (i.e., buyer risk). More often, risks linked to the country of importation form obstacles to private sector involvement (i.e., country risk). See M. Stephens, *The Changing Role of Export Credit Agencies* (Washington DC: International Monetary Fund, 1999), 156 pp., at 14; Auboin and Meier-Ewert, above n 2030, at 3; Wang, Mansilla, Kikuchi, and Choudhury, above n 2032, at 5.

2057 Wang, Mansilla, Kikuchi, and Choudhury, above n 2032, at 21 and 22. Several economists question the validity of this argument in practice. See Ray, above n 2051, at 12-13; WTO Secretariat, *World Trade Report 2006 – Exploring the Links Between Subsidies, Trade and the WTO* (Geneva: WTO Publications, 2006), 223 pp., at 74; Zehner, above n 2051, at 5-8.

2058 ECAs might also be better placed to pursue claims. Wang, Mansilla, Kikuchi, and Choudhury, above n 2032, at 5; Zehner, above n 2051, at 7-8.

2059 It might be possible that ECAs' functioning precisely inhibits the private sector from further developing.

2060 As ECAs do not have to pay taxes and make profit, their risk-absorbing capacity is higher than private actors even when they have to operating break-even. Hence, a more developed financial system would not necessarily finance the same trade transactions as those supported by ECAs operating break-even.

support might be used as a carrot-and-stick instrument.[2061,2062] Second, because export credit support ensures financing to importers, ECAs in developed countries also find legitimacy in financing trade to developing countries and enhancing trade in general. Obviously, foreign buyers benefit from export credits at terms not available on the commercial market. These rationales outside the capital market might, from the export-promoting country's perspective, justify official support even if this would not be commercially sound.[2063,2064]

Next to simple political-economy reasons (i.e., responding to lobbying efforts of exporters), these different rationales explain why today virtually all developed countries and many developing countries have government support programmes for export credits in place. By 1970, most major OECD countries had created an ECA. Developing countries also actively started to set up ECAs as an export promotion tool over the past 30 years.[2065] Nonetheless, the private sector is increasingly occupying aspects of the trade finance market, certainly in the short-term credit segment.[2066,2067] Nonetheless, an IMF study as well as discussions in the

[2061] See above Part I, Chapter 2, Section 2.4.3. In oligopolistic markets (e.g., aircraft), in which firms behave as Cournot competitors and governments act first, subsidized export credits could also be used as profit-shifting instruments (from foreign to domestic firms). According to Carmichael, however, it is more realistic to assume that firms compete on price (i.e., Bertrand competitors) and act first in the field of export credit support. In this case, the inflated subsidy level is merely a response to a firm's rent-seeking behaviour reacting to an inflated stated price. See C. M. Carmichael, 'The Control of Export Credit Subsidies and its Welfare Consequences', 23:1/2 *Journal of International Economics* (1987), 1-19.

[2062] From a normative viewpoint, this could legitimize export credit support in developing countries as market failures often hamper the expansion of the exporting sector (see above Part I, Chapter 2, Section 2.4).

[2063] A fully informed/developed private sector would also be unwilling to cover the risk of (or finance) this trade transaction at the same premium rate (interest rate). It correctly assesses the risks but does not internalize the alleged positive external effects of the trade transaction. In contrast, official export credit support 'internalizes' these effects. Such support might thus entail costs to the governments and bear the risk of competing with the private sector by overriding less favourable private offers. Of course, the question should be addressed if the government is indeed driven (instead of captured by interest groups) ánd able (benefits are greater than costs) to internalize these effects. Its support might also be cancelled out by similar support given by other countries to their exporters.

[2064] Notice that only if this argument would be present to justify export credit support (e.g., welfare-improving effect on net-importing countries), it could not be justified in simple welfare terms from the perspective of the subsidizing country. It would then be seen as a kind of development instrument, which incurs a welfare cost upon the subsidizing country. From a normative viewpoint, other types of development support would be superior.

[2065] M. Stephens and D. Smallridge, 'A Study on the Activities of IFIs in the Area of Export Credit Insurance and Export Finance', *Inter-American Development Bank, Occasional Paper* No. 16 (2002), 53 pp., at 5; Wang, Mansilla, Kikuchi, and Choudhury, above n 2032, at 5.

[2066] In most industrial countries, ECAs are already replaced by the private sector as the main provider of short-term credits (maximum repayment of 1-year). ECAs are also facing increased competition in the medium- and long-term credit markets even though they still have a dominant position in these markets. The growth of the private trade finance market explains why official support for export credit by ECAs in industrial countries has been on the decline. In contrast, such official support is growing in large emerging markets (e.g., China, India). Wang, Mansilla, Kikuchi, and Choudhury, above n 2032, at 10, 11, 16. Yet, in response to the financial crisis, ECAs have again increased their short-term export credit support.

WTO show that government support for trade finance could still be justified in two broad areas.[2068]

First, ECAs could fill gaps where the private capital market is still unwilling or unable to provide financing. These gaps are still present in medium- and long-term markets, predominantly in developing countries because of the underdevelopment of their capital markets. Discussions under the Aid-for-Trade programme have also revealed that there still is a lack of trade finance to low-income countries, hindering their integration into world trade.[2069] WTO Members and international institutions were called upon to spur trade finance support and help developing efficient trade finance institutions in these countries. Because of their intense dialogue with the WTO, ECAs of developed countries are considered 'natural partners' to participate in the Aid-for-Trade initiative and to provide technical assistance in setting up ECAs in developing countries.[2070,2071] In response to the financial crisis, several developing countries have requested such assistance to set up ECAs (e.g., Vietnam, Cambodia, Costa Rica).[2072] Further, to help bridging the gap in trade financing in emerging markets, international as well as regional financial institutions have developed specific instruments in this field. For instance, the International Finance Corporation (IFC), which is part of the World Bank Group[2073], as well as three Regional Development Banks[2074] have set up so-called 'Trade Finance Facilitating Programmes' (TFFPs). Under these programmes, they provide guarantees to international or regional banks (so-called 'confirming banks') covering both the commercial and political risk of international trade related credit transactions emanating from local banks (so-called 'issuing banks').[2075] By absorbing the risk on non-payment of the local banks (i.e., 'issuing bank'), the Global TFFP set up by the IFC

2067 Several ECAs and private providers of export credits and investment insurance are members of the Berne Union (founded in 1934, currently 51 Members), which functions as a forum to discuss and formulate good practices in the sector.

2068 Wang, Mansilla, Kikuchi, and Choudhury, above n 2032, at 21-22.

2069 Technological innovations in handling trade finance in developed markets even bear the risk of further marginalization. Auboin, above n 2024, at 2; Auboin, above n 2031, at 22-23; see also *Note by the Secretariat, Expert Group Meeting on Trade Finance – 25 April 2008* (WT/WGTDF/W/38, 14 July 2008) and Working Group on Trade, Debt and Finance, *Report of the Meeting of 10 July 2008* (WT/WGTDF/M/16, 17 July 2008).

2070 Auboin, above n 2024, at 16

2071 Somewhat ironically, ECAs seem to perceive this partnership as a helpful tool to correct their traditional negative image of subsidizing national goods and violating international subsidy rules. Auboin, above n 2024, at 16 (footnote 34).

2072 Auboin, above n 2031, at 22.

2073 Within the World Bank Group, the Multilateral Investment Guarantee Agency (MIGA) also offers guarantees covering political risks for *investments* in developing countries. These political risks cover currency inconvertibility and transfer restrictions, expropriation, war and civil disturbance, and breach of contract by the host country. In principle, the applicant for the guarantee must be a national of a country other than the country where the investment is made. MIGA offers coverage for up to 15 years (or 20 years if justified by the project)

2074 These banks are the European Bank for Reconstruction and Development (EBRD), the Inter-American Development Bank (IDB), and the Asian Development Bank (ADB).

2075 The issuing bank bears the risk related to the local producer.

thus facilitates import and export transactions to/from all emerging markets. Likewise, the three Regional TFFPs support trade transactions to/from emerging countries within their particular region.[2076,2077] Another example of a multilateral institution active in the trade finance field is 'The African Trade Insurance Agency' (ATI). Created in 2001 by a number of African countries with support of the World Bank, ATI offers *inter alia* export credit insurance covering both commercial and political risks.[2078]

Second, official export credit support might be particularly justified in times of financial crisis. The Asian financial crisis at end of the 1990s had already demonstrated that ECAs could be important in times when private banks collectively cut trade credit lines to emerging market economies and this regardless of the risks involved (so-called 'herd behavior').[2079] The fact that even companies with good credit ratings could not get access to financing indicated the presence of a capital market failure, which justified the intervention of ECAs.[2080] In general, such capital market failure could result, *inter alia*, from overshooting (irrational component), a lack of information during a financial crisis to distinguish between risks, and/or a lack of capacity to finance all creditworthy transactions. Moreover, official export credit support during a financial crisis is also legitimized on the basis of the recovering – or so-called 'shock-absorbing' – role of trade.[2081] Private finance actors do not take into account the negative externalities of cutting trade credit.[2082] The global financial crisis that hit the world in 2008 caused a sharp deterioration of trade financing, especially to emerging and low-income market economies, which resulted from a shortage of liquidity as well as a from a re-assessment of risks.

The capital market failure in combination with the shock-absorbing role of trade might thus legitimize the promise of the G-20 in April 2009 to increase governmental support for trade

[2076] Hence, it covers trade transactions to, from, and within (i) all emerging markets (IFC); (ii) countries in central and eastern Europe and the Commonwealth of Independent States (EBRD); (iii) countries in the Latin American and Caribbean region (IBD); and (iv) Asian countries qualifying as developing countries under the ADB classification (ADB). The issuing banks are thus located in these countries.

[2077] The Regional Development Banks also have other trade finance programmes in place. The EBRD and ADB, for instance, also directly provide credit facilities to banks in their regional emerging markets for lending to exporters and importers.

[2078] See http://www.ati-aca.org/. To be sure, despite these efforts by the ATI and the IFC of which almost half of its guaranteed transactions were for banks in Africa, demand for funds and guarantees still outweighs supply in Africa. See Auboin, above n 2031, at 13.

[2079] Wang, Mansilla, Kikuchi, and Choudhury, above n 2032, at 22 and 25; WTO, Working Group on Trade, Debt and Finance, *Note by the Secretariat, Improving the Availability of Trade Financing: Report of Preliminary Work* (WT/WGTDF/W/23, 25 March 2004), paras 20-28; Auboin, above n 2031, at 8.

[2080] WTO, Working Group on Trade, Debt and Finance, above n 2079, paras. 18 and 20-28. ECAs in non-crisis countries could play a signalling role by providing sufficient trade finance (for short-term and investment) to countries enduring a financial crisis. Wang, Mansilla, Kikuchi, and Choudhury, above n 2032, at 22 and 25; Auboin and Meier-Ewert, above n 2030, at 10.

[2081] In the words of Lamy, the Asian financial crisis has demonstrated that 'access to trade finance at affordable rates must be maintained in such critical times to ensure that international trade can continue to play its shock-absorbing role'. He warned that, if the gap in trade financing is not filled, 'we run the risk of further exacerbating [the] downward spiral' of the world economy. WTO, above n 2025.

[2082] See WTO, above n 2025.

financing. In implementing this pledge, the IFC and all regional development banks doubled their capacity under their trade facilitation programmes[2083] and ECAs have also 'stepped in essentially with programmes for short-term lending of working capital and credit guarantees aimed at SMEs (small- and medium enterprises)'.[2084] Nonetheless, in spring 2010 Lamy warned before the IMF's International Monetary and Financial Committee that any recovery of the trade finance market might not benefit low-income countries:

> (D)espite the improvement in core markets — i.e. the financing of north-north and trans-pacific trade — at the periphery markets are still in dire conditions. The confusion of country and counterparty risk is leaving low income countries on the side of the road, and, in current bank restructuring, trade financing is not necessarily a priority relative to more remunerative, short-term market activities. The risk of a permanent withdrawal by international banks from low-income markets is real at a time when regulatory change may not make it easier to do business.[2085]

Therefore, he urged addressing this risk 'if we want low-income countries not to be overly constrained in benefiting from the global recovery'.[2086] This again demonstrates that the WTO Director-General is one of the driving forces pushing for government intervention to close the gap in short-term trade financing. For ECAs, the fact that they were among those assigned to fulfil this task came as a surprise. This is illustrated in the 2009 US Ex-Im Bank report to US Congress: 'The WTO, contrary to its otherwise negative stance regarding the use of export credit subsidies, supported the notion that ECAs had a clear role to play, particularly in the area of trade (short term) finance'.[2087] To be sure, it is the WTO Secretariat, and the WTO Director-General in particular, who support the ECAs' complementary role in tackling the financial crisis.[2088] As our discussion will illustrate, existing WTO disciplines seem far less supportive to this end.

[2083] The ceiling of the IFC's Global TFFPs increased from \$1.5 billion to \$3 billion. In addition, a new 'Global Trade Liquidity Program' was launched in May 2009, resulting from a joint initiative between governments, international and regional financial institutions, and the private sector to support trade financing to importers and exporters in developing countries.

[2084] Auboin continued:

> 'For certain countries, the commitment is very large or unlimited in amount (Germany, Japan). In other cases, very large lines of credit have been granted to secure supplies with key trading partners (the USA with Korea and China). In other cases, cooperation is developing to support regional trade, in particular chain-supply operations (establishment of an Asia-Pacific Trade Insurance Network to facilitate intra- and extra- regional flows)'.

See Auboin, above n 2031, at 16-19; see also G-20, *Progress Report on the Actions of the London and Washington G-20 Summits* (5 September 2009); G-20, *Progress Report on the Economic and Financial Actions of the London, Washington and Pittsburgh G20 Summits* (7 November 2009).

[2085] WTO, News, *Lamy at IMF/World Bank underlines trade's role in anchoring economic recovery* (24-25 April 2010), available at: http://www.wto.org/english/news_e/sppl_e/sppl154_e.htm.

[2086] WTO, above n 2025.

[2087] Export-Import Bank of the United States, above n 2045, at 88.

[2088] On the role played by the WTO Secretariat and the WTO Director-General, see J. Pauwelyn and A. Berman, 'Emergency Action by the WTO Director-General: Global Administrative Law and the WTO's Initial Response to the 2008-09 Financial Crisis', 6:2 *International Organizations Law Review* (2009), 499-512.

1.3. RATIONALES FOR AND PROVISION OF EXPORT CREDIT SUPPORT TO AGRICULTURAL PRODUCTS

Trade finance for agricultural products is mostly short-term in nature. Hence, export credit support for such transactions is less evidently justified on the basis of capital market failures given that these occur primarily in medium- and long-term markets. Instead, such support is generally considered justified by its proponents on the basis of the positive impact upon net food-importing countries. Yet, even though such support could be welfare-improving for net food-importing countries (static perspective), it might likewise inhibit the development of local production (dynamic perspective). Moreover, from the perspective of world welfare, the beneficial impact of export credit support upon developing importing countries cannot justify subsidized export credit support from a normative perspective given that its welfare effect on the world as a whole is negative: in welfare terms, the subsidizing exporting country and foreign competitors lose. Indeed, as covered in Part I, export subsidies are welfare-depressing from a world welfare perspective in the absence of market failures.[2089] Nonetheless, according to an OECD study, official support for agricultural products could be legitimate in the presence of serious liquidity constraints in the importer's market.[2090][2091] If a country faces systematic liquidity constraints[2092] and agricultural imports are a high priority[2093], export credit support could create additional global demand that otherwise would not have existed.[2094] The resulting higher exports would not come at the expense of other exporters or local production in terms of their existing sales.[2095] This argument could justify agricultural export credit support to importers in least-developed countries (LDCs) or net food-importing countries as it allows them to purchase vital amounts of foods which they otherwise would have been unable to import.[2096] Rude and Gervais also formally demonstrate that rules

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[2089] See above Part I, Chapter 1.

[2090] OECD, *An Analysis of Officially Supported Export Credits in Agriculture* (COM/AGR/TD/WP(2000)91/FINAL, 2001), 62 pp.

[2091] Liquidity constraints occur 'when an importer lacks sufficient foreign exchange to import desired foodstuffs and has difficulties in obtaining credit' and are mostly explained on the basis of incomplete markets. J. Rude and J-P. Gervais, 'An Analysis of a Rules-based Approach to Disciplining Export Credits in Agriculture', 21:3 *International Economic Journal* (2007), 441-463, at 445.

[2092] 'Systematic' means that liquidity constraints are widespread among importers and not just limited to some of them.

[2093] For example, if additional food is required to feed the population.

[2094] 'Export credits may increase demand if, like an increase in income, they increase demand at any price'. OECD, above n 2090, at 22.

[2095] 'Additionality' is restrictively defined as export credit policies causing an increase in demand at any price. But even in that case, the results are considered ambiguous because the development of future domestic production/imports or private trade financing might be hampered. OECD, above n 2090, at 22 and 25.

[2096] OECD, above n 2090, at 22.

disciplining interest rate subsidies may not be appropriate in case of liquidity constraints because of this potential for additionality and benefits for all exporting countries.[2097]

The same OECD study also gives insights in the amount of agricultural export support offered in the second half of the 1990s by countries participating in the OECD Arrangement.[2098] Even though the EC is by far the largest provider of export subsidies for agriculture, most agricultural export credit support was extended by the US (46 per cent of the total), followed by Australia, the EC, and Canada.[2099] The support offered by the US was most trade-distortive as well, as it contained the highest subsidy rate (almost 5 per cent).[2100] Moreover, the US accounted for most export credit on terms of more than one year.[2101] The amount of the subsidy element of the support offered by the US, Canada, and Australia exceeded their level of export subsidy notifications in the WTO.[2102] On the other hand, few emerging developing countries offered export credit support for agricultural products.[2103] For reasons of food security and fiscal policies, agricultural exports are more often taxed than subsidized in developing countries. Remarkably, agricultural export support is not only primarily extended by OECD countries but these countries were also the main recipients thereof.[2104] The very limited share of support channelled to net food-importing countries and LDCs reveals that the above-mentioned justification for export credit support might not hold in

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[2097] An export credit at subsidized rates can relax the liquidity constraints of importers and thus increase their demand. If this demand-inducing effect (putting upward pressure on the price) outweighs exporters' supply-inducing effect (putting downward pressure on the price), the price increases, even if more of the good is traded. On the other hand, in Rude and Gervais model, rules on minimum premium rates are always appropriate, as insurance subsidies unambiguously have the potential to distort markets. Apparently, differential treatment in case LDCs and net food-importing countries are recipients with respect to minimum premium rules cannot be justified on the basis of liquidity constraints. However, the different outcome with regard to interest rate rules and premium rate rules emerges from the model's assumption that premiums at subsidized rates only affect the exporter's cost and is not passed through in any way in a discounted interest rate. As a result, minimum premium rates only affect the supply side and not import demand in their model. Yet, as Rude and Gervais also acknowledge, 'a credit guarantee allows the home country exporters to charge a lower interest rate because the risk associated with the transaction is lower'. However, this indirect effect on the interest rate is not reflected in their model. Rude and Gervais, above n 2091, at 441- 463.

[2098] To be precise, the survey covered export credit support offered by the Participants to the OECD Arrangement over the period 1995-1998. According to information provided to the WTO Secretariat, the average annual amount (period 1995-1998; in US$ million) of agricultural products supported by official export credits were 3297 (US), 905 (Canada) and 885 (EC). See *Background Paper by the Secretariat, Members' Usage of Domestic Support Categories, Export Subsidies and Export Credits – Revision* (G/AG/NG/S/12/Rev.1, 12 March 2001), at 44.

[2099] These four countries accounted for almost all export credit support (99 per cent).

[2100] The premium rates were considered insufficient to cover long-term operating costs. See OECD, above n 2090, at 15.

[2101] In total, 45 per cent of export credits were on terms of more than 1 year and the US accounted for 97 per cent thereof. OECD, above n 2090, at 16.

[2102] OECD, above n 2090, at 31.

[2103] OECD, *Agricultural Policies in Emerging and Transition Economies – 2000* (COM/AGR/APM/TD/WP(2000)43/FINAL, June 2000), 153 pp., at 44.

[2104] See also OECD, above n 2103, at 49.

practice.[2105] Overall, the subsidy rate as well as the importance of export credit support in total trade of agricultural products was reported to be not very large. Nevertheless, the OECD study called for strengthening disciplines on agricultural export credit support, because such support could be trade-distortive in individual cases and its current levels might increase in the future. Interestingly, the OECD study assumed that no such international disciplines were in place but, as the *US – Upland Cotton* case has revealed, this turned out to be incorrect.[2106]

Unfortunately, a follow-up empirical study of a more recent date is lacking. Yet, some insights on WTO Members' export credit support for agricultural products might be drawn from the operation of the WTO's dispute settlement system and the Trade Policy Review (TPR) mechanism. First, the US substantially altered its export credit support for agricultural products in response to the US – Upland Cotton rulings discussed below. Under the 2008 Farm Bill, only one export credit guarantee programme for agricultural products is still in force, operated by the Commodity Credit Corporation (CCC). This programme, the so-called General Sales Manager 102 (GSM 102), guarantees the repayment of credit made available to finance commercial export sales of agricultural commodities on credit terms that do not exceed three years.[2107,2108] In order to conform to the US – Upland Cotton compliance rulings, the 1% (of the value of the guaranteed transaction) statutory cap on the premium charged to the exporter has been removed.[2109] The level of export credit guarantees that the CCC must make available annually under the GSM 102 programme should be minimum \$5.5 billion and the available credit subsidy, referring to the available budget authority for the cost of the programme, is set at \$40 million annually.[2110]

Second, in Canada's 2007 Trade Policy Review (TPR), the functioning of its export credit programmes for agricultural products was discussed. These programmes are operated through Canada's official ECA ('Export Development Canada' or EDC) and through the

[2105] OECD, above n 2090, at 24-25.
[2106] OECD, above n 2090, at 8.
[2107] The minimum term of 90 days is deleted under the 2008 Farm Bill. The 2008 Farm Bill gives funding authority for credit guarantees through FY2012. See, Farm Bill 2008 (H.R. 6124), at 470-473; See C. E. Hanrahan, 'Agricultural Export Provisions of the 2008 Farm Bill', *CRS Report for Congress* (June 2008), 5 pp., at 2-3.
[2108] The 2008 Farm Bill repealed the statutory authority of the CCC to extend pure cover support under the 'Supplier Credit Program' (SCGP), which offered very short-term guarantees (up to 180 days), as well as under long-term (3-10 years) guarantee programme 'General Sales Manager 103' (GSM 103). Both programmes (i.e., SCGP and GSM 103) were already suspended in 2005 (See Appellate Body Report, *US –Upland Cotton (Article 21.5 – Brazil)*, paras 192 and 258). The SCGP had incurred a large number of defaults (\$227 million in total) and had been plagued by fraud. See also WTO, Trade Policy Review Body, *Trade Policy Review US – Minutes of Meeting – Addendum* (WT/TPR/M/200/Add.1, 9 September 2008), at 277.
[2109] Hanrahan, above n 2107, at 3; WTO, Trade Policy Review Body, *Trade Policy Review US*, above n 2108, at 276.
[2110] See Hanrahan, above n 2107, at 3. According to the manager's statement accompanying the Bill, the credit subsidy of \$40 million is expected to finance \$4 billion annually.

'Canadian Wheat Board' (CWB), which is a state-owned enterprise that has the exclusive right to sell wheat and barley in Western Canada for export and domestic consumption.[2111] According to Canada, the relevant EDC programmes operate on commercial principles, charge premiums reflecting the transaction risk, and are benchmarked against the private sector.[2112] Answering questions on official guarantees extended on credit offered by CWB to foreign buyers[2113], Canada emphasized that 'to date, there has been no WTO agreement on rules governing the extension of export credit or export credit guarantees'.[2114] Yet, this response does not seem accurate in light of the *US – Upland Cotton* case.

Third, some large emerging developing countries also started to set up export credit support facilities for agricultural products in line with the general trend of reducing their agricultural policy's anti-export bias.[2115,2116] For instance, in 2001 India created a specific agriculture division under its ECA (Exim Bank Agro).[2117,2118] In China, the Export & Credit Insurance

[2111] The operation of the CWB as state-trading enterprise was central in the case *Canada – Wheat Exports and Grain Imports* in which the Appellate Body agreed with the panel that the CWB 'export regime' was not inconsistent with Article XVII of the GATT, as sales did not result in a violation of the GATT's non-discrimination principle nor were contrary to commercial considerations. See, Panel Report, *Canada – Wheat Exports and Grain Imports*; Appellate Body Report, *Canada – Wheat Exports and Grain Imports*.

[2112] See WTO, Trade Policy Review Body, *Trade Policy Review – Canada – Minutes of Meeting – Addendum* (WT/TPR/M/179/Add.1, 22 June 2007), at 255.

[2113] These are extended under two government-guaranteed export credit programmes. First, the Credit Grain Sales Program (CGSP) guarantees export credits to foreign *sovereign* buyers with terms up to three year. According to Canada's 2007 TPR, however, this programme has not been used anymore for new credits since the 2001/2002 crop year. Second, the Agri-Food Credit Facility (ACF) guarantees credits offered by CWB to foreign *private* buyers, which (as there are no limits set out by law or regulation) in practice have terms up to one year and for which no premium at all is charged. Canada indicates that most CWB sales are made on a cash basis. Yet, in some cases, the government offers export credit guarantees to the CWB, allowing it to make credit sales to creditworthy buyers. Canada's 2007 TPR reveals that credit sales under the ACF amounted to between 3% and 4% of total sales during 2002/3 and 2003/4. According to CWB, these 'small amounts of export credit' are offered 'to compete with other exporting countries providing such support'. If the CWB sells on credit, it charges an interest rate to foreign buyers, while at the same time borrowing credit to pay the Canadian exporter. Given that the CWB is able to borrow at a lower interest rate than the interest rate charged to foreign buyers as CWB's debt is guaranteed by the government, it is able to generate a positive interest spread. See Canadian Wheat Board, 'Position on Trade' (available at http://www.cwb.ca/public/en/hot/trade/position/); WTO, Trade Policy Review Body, Trade Policy Review, *Report by the Secretariat, Canada* (WT/TPR/S/179/Rev.1, 4 June 2007), at 97-98; WTO, Trade Policy Review Body, above n 2112, at 255; CWB, 'Annual Report CWB – Annual Report – 2008/2009', at 63, 73, 83.

[2114] Trade Policy Review Body, above n 2112, at 209.

[2115] On the general trend to reduce the anti-export bias, see K. Anderson, 'Distorted Agricultural Development and Economic Development: Asia's Experience', *The World Economy* (2009), 351-384, at 362-365.

[2116] In 2000, the OECD observed that few emerging economies offered agricultural export credit support. OECD, above n 2103, at 44.

[2117] See http://www.eximbankindia.in/sme.asp and http://www.eximbankagro.com/

[2118] The Agro and Food Processing sector accounted for 5% of the exposure of the Indian Exim Bank in 2006. WTO, Trade Policy Review Body, *Trade Policy Review – India – Minutes of Meeting – Addendum* (WT/TPR/M/182/Add.1, 20 July 2007), at 292.

Corporation (SINOSURE), set up in 2001 after its WTO accession[2119], has introduced special export insurance for agricultural products.

Overall, export credit support for agricultural products does not seem not be used as widely as export credit support for industrial products are. Yet, both the fact that some programmes are challenged before the WTO and the discussions in the TPR framework reveal concerns about their trade-distortive potential. We now turn to the historical context explaining why countries have agreed upon international disciplines restricting their freedom to offer export credit support for industrial as well as for agricultural goods.

[2119] It merged the export credit insurance arm of the China Export and Import Bank and the People's Insurance Company of China.

2. RATIONALE FOR DISCIPLINING EXPORT CREDIT SUPPORT: HISTORICAL CONTEXT

The need for multilateral disciplines on export credit support can generally be explained on the basis of simple game theory principles. Competition among ECAs to offer their exporters the best support has severe budget implications and, by canceling out each others' offers, could result in a zero-sum operation whereby no one wins market share.[2120] However, given that no country can unilaterally decide to stop subsidizing export credits without its exporters losing sales (prisoner's dilemma), an important incentive for drafting multilateral disciplines comes into existence.[2121] To this end, two parallel though related tracks were developed for disciplining export credit support for non-agricultural products, one within the OEEC/OECD and another within the GATT/WTO, each having their own compliance mechanism in place. In the case of agricultural products, political-economy reasons and lower levels of support might explain why disciplines on export credit support for these goods were only discussed much later.

2.1. EXPORT CREDIT SUPPORT FOR NON-AGRICULTURAL PRODUCTS

In the early postwar period, governments became active in providing export credit support. Initial discussions for disciplining such support took place in the Organization for European Economic Cooperation (OEEC).[2122] Already in 1955, the OEEC succeeded to adopt an initial list of prohibited measures that were considered to artificially aid exporters.[2123] At that time, no substantive disciplines in the GATT regulated the use of export subsidies. Only in 1960, Contracting Parties could agree on a declaration that elaborated a non-exhaustive list of prohibited export subsidies on non-primary goods (1960 Declaration).[2124] As mentioned in Part II, this list was based on the one drafted in the OEEC, which was transferred to the GATT when the OEEC transformed into the OECD in 1960.[2125] Among the practices considered as prohibited export subsidies were:

[2120] Of course, export credit support often has a trade-creating effect. Governments would support disciplines 'when the subsidization required to maintain competitiveness outstripped their institutional capacity to pay'. A. M. Moravcsik, 'Disciplining Trade Finance: the OECD Export Credit Arrangement', 43:1 *International Organization* (1989), 173-205, at 193-194.

[2121] See also A. I. Mendelowitz, 'The New World of Government-Supported International Finance', in G. C. Hufbauer and R. M. Rodriguez (eds), *The Ex-Im Bank in the 21st Century – A New Approach?* (Washington DC: Institute for International Economics, 2001), 159-190, at 161.

[2122] The first serious calls for disciplines were made by France and the UK in the 1950s when US exports, backed by low-interest and long-term credits of the US Ex-Im Bank, threatened their dominant position in their increasingly unprotected colonial markets. See Moravcsik, above n 2120, at 179.

[2123] This list was further expanded in 1958.

[2124] See above Part II, Chapter 1.2.

[2125] This was done upon request of France. See *Subsidies – Action by the Contracting Parties under Article XVI:4* (L/1260, 1 August 1960); *Contracting Parties, Seventeenth Session, Subsidies – Action under Article XVI:4* (W.17/3, 2 November 1960).

> (f) in respect of government export credit guarantees, the charging of premiums at rates which are manifestly inadequate to cover the long-term operating costs and losses of the credit insurance institutions; (g) the grant by governments (or special institutions controlled by governments) of export credits at rates below those which they to pay in order to obtain the funds so employed; (h) the government bearing all or part of the costs incurred by exporters in obtaining credit.[2126]

The list thus referred to the cost to the government in deciding whether export credit support was prohibited.[2127] Despite the fact that this standard was considered far too high and, as a result, 'almost universally ignored', no GATT complaint was brought, partly because the time-consuming dispute settlement procedure was inadequate to respond to fastly negotiated trade finance transactions.[2128]

Consequently, the OECD resumed the topic of export credit support in the early 1960s, but no substantive disciplines emerged in the following decade mainly due to US objections. Being well aware of its low domestic interest rates, the US proclaimed that 'credit terms were an element of competition, comparable to cheaper labor or higher productivity'.[2129] However, the first oil crisis turned the US into the main advocate for stricter disciplines.[2130] In 1978, negotiations finally resulted in the 'Arrangement on Guidelines for Officially Supported Export Credits' (OECD Arrangement).[2131] This OECD Arrangement is not a formal treaty but a so-called 'gentlemen's agreement among its Participants' of indefinite duration.[2132] It is also not an OECD act, though the OECD Secretariat provides administrative support and monitors its implementation.[2133] Accordingly, the OECD Arrangement is a flexible, non-legally binding instrument in the hands of its Participants who can modify it without having to follow the OECD decision-making procedures or ratification process.[2134] In contrast to the GATT's institutional design, the OECD offered a neutral forum, which explains, pursuant to

[2126] See *Contracting Parties, Seventeenth Session, Report of the Working Party on Subsidies* (L/1381, November 1960), para 5.
[2127] Except for item (h), which referred to the cost to the exporter.
[2128] Moravcsik, above n 2120, at 179; G. C. Hufbauer and J. S. Erb, *Subsidies in International Trade* (Washington DC: Institute for International Economics, 1984), 283 pp., at 68.
[2129] Cited in Moravcsik, above n 2120, at 196. The Working Party on Export Credits and Credit Guarantees (ECG) was set up in 1963. Today, all OECD Members, except for Iceland, are Members of the ECG. The EC is not a Member of the OECD but a Participant to the OECD Arrangement and also participates in the meetings. The WTO acts as an observer.
[2130] France made the opposite move. The US feared that the balance-of-payment consequences of the oil crisis could end in an export credit war. Moravcsik, above n 2120, at 180 and 201.
[2131] The first steps to an agreement were not made in the OECD but in the IMF/World Bank annual meeting in 1973. Subsequent negotiations in the IMF, OECD, and G-5 summits resulted in a secret, non-binding Consensus in 1976, which was formalized two years later under the OECD.
[2132] Article 2 of the January 2010 version of the OECD Arrangement (see below n 2153).
[2133] Articles 2, 9 of the January 2010 version of the OECD Arrangement (see below n 2153). Interaction and information exchange exists between the Participants to the Arrangement and the ECG. See Export Credits Secretariat, above n 2033.
[2134] Entrance is upon invitation of Participants (Article 3 of the current OECD Arrangement). See also J. Koven Levit, 'The Dynamics of International Trade Finance Regulation: The Arrangement on Officially Supported Export Credits', 45 *Harvard International Law Journal* (2004), 65-148, at 114-118.

Moravcsik, why it became the institutional home of export credit disciplines.[2135] The original OECD Arrangement spelled out disciplines for export credits with a repayment term of minimum two years that were supported by ECAs for sales of non-primary products and services. Minimum interest rates for official *financing* support (7 to 8 per cent) and maximum repayment terms were prescribed. However, no minimum premium rates were drafted.[2136] Export credits supported by pure cover were subject to the substantive disciplines *except* for the minimum interest rates. In other words, an important loophole – used by several countries – was that ECAs could offer guarantees/insurance to export credits provided by private parties at interest rates below the prescribed threshold.[2137] In addition, Participants were allowed to offer the same level of support than other Participants did in case the latter deviated (or applied an exception) from the disciplines set under the Arrangement (so-called 'matching'). Contrary to GATT's mandatory dispute settlement system, the enforcing mechanism of this gentlemen's agreement is based on the threat of such matching.

During the same period the OECD Arrangement was drafted, GATT contracting parties were negotiating stricter disciplines on the use of non-tariff barriers in the Tokyo Round. As elaborated in Part II of this study, the plurilateral Subsidies Code resulting from this round principally prohibited the use of export subsidies on non-primary goods (except for developing countries) and included a non-exhaustive list which built on the 1960 Declaration.[2138] Concerning export credit support , however, the Subsidies Code inscribed more flexibility than under the 1960 Declaration. The basic principles on export credit support were formulated in line with the 1960 Declaration. Item (j), dealing with export credit guarantees/insurance, prescribed that premium rates could not be manifestly inadequate to cover the cost to the government.[2139] Next, item (k) described the conditions under which official financing support was prohibited (para 1). Yet, the Subsidies Code also built in an exception for export credit practices in accordance with the interest rate provisions of the OECD Arrangement (item (k), para 2). Such a 'safe haven' was necessary as the standard imposed under paragraph 1 of item (k) (and (j)) was much more demanding than the obligations imposed under the recently drafted OECD Arrangement.[2140] Next to disciplines

[2135] The OECD contributed 'simply a location for treasury and credit agency officials to continue what they were already doing'. Moravcsik, above n 2120, at 198.
[2136] Some other sectors next to agriculture were also excluded at that time.
[2137] See also Moravcsik, above n 2120, at 182.
[2138] Articles 8, 9, 14 and the Annex of the Subsidies Code. See above Part II, Chapter 1, Section 1.3.
[2139] Item (j) elaborated upon item (f) of the 1960 Declaration
[2140] See Hufbauer and Erb, above n 2128, at 70. Notice that this safe haven was inscribed as an exception to item (k) and not as an exception to item (j). Hence, one might wonder whether the safe haven was only intended to provide an exception to item (k), first paragraph, or also to the standard set in item (j) for pure cover support. Next to the fact that the safe haven was inscribed in item *k*, other elements might also suggest that the safe haven was not intended to cover item (j) violations. First, contrary to today,

on export and domestic subsidies, the Subsidies Code elaborated obligations on the use of CVDs.[2141] Because drafters had failed to agree on a general 'subsidy' definition, it was unclear which trade-distortive government measures could be countervailed. Contracting Parties disputed whether the Illustrative List of prohibited 'export subsidies' also defined – and thus restricted – the concept of 'subsidy' for CVDs purposes.[2142] For instance, could products benefiting from export credits conforming to the OECD Arrangement be countervailed if such credits were offered at a cost to the government?[2143] The EC argued that these should not be considered as subsidies and therefore could not be countervailed, but the US and several other countries held the opposite view.[2144]

With the launch of the Uruguay Round (1986), Contracting Parties also tabled negotiations on disciplines on subsidies and CVD disciplines. The US proposed a number of amendments to items (j) and (k) in order to strengthen these disciplines.[2145] At the same time, it was questioned whether it could still be left to OECD Arrangement Participants to define the conditions under which export credit support could be provided.[2146] The application of the

direct credits were at that time much more common than pure cover support. Therefore, the focus was oriented on disciplining (and providing an exception for) official financing support. Second, the standard in item (j) for pure cover support relates to the level of premium, whereas the original OECD Arrangement did not impose any minimum premium obligations. Put otherwise, in case the safe haven applied to item (j) violations, pure cover support at premiums incurring a cost would have been justified under the safe haven, simply because the repayment terms would have been respected. Third, if the drafters would have intended to justify item (j) violations, they would probably not have referred to 'interest rate provisions' in the safe haven as pure cover support was (and still is) not subject to these provisions. Finally, the Knaepen package (1999) exactly introduced disciplines on minimum premium rates with the objective to comply with the standard set by item (j). On the other hand, the safe haven's phrase 'export credit practice' might indicate that it was intended to cover all types of export credit practices, including pure cover support (item (j)). On this basis, the case law considers that the safe haven could *potentially* be invoked as an exception to a pure cover support programme violating item (j) (see below).

2141 Articles 1-6 of the Subsidies Code.

2142 See J. H. Jackson, 'Perspectives on CVDs', 21 *Law & Policy in International Business* (1990), 739-761, at 747; G. C. Hufbauer, J. S. Erb, and H. P. Starr, 'The GATT Codes and the Unconditional Most-Favored-Nation Principle', 21 *Law & Policy in International Business.* (1980), 59-93, at 72-73.

2143 See K. Adamantopoulos, 'Subsidies in External Trade Law of the EEC: Towards a Stricter Legal Discipline', 15:6 *European Law Review* (1990), 427-459, at 452.

2144 According to Adamantopoulos as well, the latter reading seems correct, above n 2143, at 435. See *Committee on Subsidies and Countervailing Measures, Minutes of the Meeting Held on 27 October 1982* (SCM/M/13, 6 January 1983), paras 19 and 25. Parallel arguments were expressed on the notification requirement. See *Committee on Subsidies and Countervailing Measures, Minutes of the Meeting Held on 29 April 1982* (SCM/M/11, 7 July 1982), paras 48-56; *Minutes of the Meeting Held on 26 April 1989* (SCM/M/43, 22 June 1989), para 24; *Communication from the Delegation of the US to the Delegation of the EC, Notification of Subsidies pursuant to Article 7:3 of the Agreement on Subsidies and Countervailing Duties* (SCM/28 and SCM/29, 9 July 1982).

2145 Negotiating Group on Subsidies and Countervailing Duties, *Submission by the US, Elements of the Framework for Negotiations* (MTN.GNG/NG10/W/29, 22 November 1989), at 3-4.

2146 Negotiating Group on Subsidies and Countervailing Measures, *Note by the Secretariat, Subsidies and Countervailing Measures* (MTN.GNG/NG10/W/4, 28 April 1987), at 80-81, 85-86; Preparatory Committee, *Note by the Secretariat, Subsidies* (PREP.COM(86)W/17, 28 April 1986), paras 5, 10;

Subsidies Code also showed that parties who did not participate to the OECD Arrangement had difficulties in obtaining information on (revised versions of) the OECD Arrangement.[2147] On the other hand, other countries pointed to its success in limiting the 'credit race' among developed countries.[2148] In the end, the SCM Agreement largely copied items (j) and (k) of the Subsidies Code. Indeed, the current text still refers to the cost-to-government standard and stipulates in paragraph 2 of item (k) of the Illustrative List a safe haven for OECD Arrangement-conforming export credit practices.[2149] In addition, the SCM Agreement included a 'subsidy' definition. Contrary to the EC's position, this definition clarifies that OECD Arrangement-conforming export credit support can still qualify as a 'subsidy' if it confers a benefit.

At the time the SCM Agreement entered into force (1995), the original OECD Arrangement had already undergone several modifications. Yet again, this mainly resulted from US pressure to bring disciplines closer to market principles.[2150] An important new step towards stronger disciplines on pure cover support was made through the Knaepen Package (1999). It introduced minimum premium rates and aimed at ensuring that the standard set by item (j) of the Illustrative List would be met.[2151] A dispute between Brazil and Canada on export credits in the regional aircraft sector was brought before the WTO in 1997/1998. Here, interpretations made by the panels and Appellate Body not only induced new proposals in the Doha negotiations, but also prompted Participants to revise the OECD Arrangement in 2003. In addition, Participants and Brazil negotiated a new Sector Understanding on Civil Aircraft (2007).[2152] All modifications were finally incorporated into a new text that entered into force on 1 January 2008. Further minor revisions led to the current version of the OECD Arrangement (January 2010), on which the following discussion will be based.[2153,2154]

Negotiating Group on Subsidies and Countervailing Measures, *Submission by India, Elements of the Framework for the Negotiations* (MTN.GNG/NG10/W/33, 30 November 1989), para 5.

2147 See, for example, Committee on Subsidies and Countervailing Measure, *Minutes on the Meeting Held on 28-30 October 1981* (SCM/M/9, 22 December 1981), at 9-10.

2148 Preparatory Committee, *Note by the Secretariat, Subsidies* (PREP.COM(86)W/17, 28 April 1986), para 5.

2149 The only significant modification was the deletion of the qualification 'manifestly' in item (j).

2150 For example, the Commercial Interest Rate Reference (CIRR), sector understandings for previously excluded sectors, and disciplines on tied aid were drafted.

2151 See OECD Trade Directorate, *Arrangement on Officially Supported Export Credits – Premium and Related Conditions: Explanation of the Premium Rules of the Arrangement on Officially Supported Export Credits (Knaepen Package)* (TD/PG(2004)10/FINAL, 6 July 2004), at 2 (footnote 2); Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 14.94.

2152 By participating in this specific Sector Understanding, Brazil became the first non-OECD country Participant in the OECD Arrangement.

2153 *Arrangement on Officially Supported Export Credits – January 2010 Revision* (TAD/PG(2010)2, 28 January 2010).

Participants to this OECD Arrangement are: Australia, Canada, the EC (which includes all 27 Member States), Japan, Korea, Norway, New Zealand, Switzerland, and the US.[2155] At the beginning of 2010, an important new step for further strengthening the OECD Arrangement was also announced. For the first time since the Knaepen Package, new disciplines to be implemented by September 2011 will substantially strengthen the rules on minimum premium rates.[2156] Relevantly, the impetus for this revision was the sharp increase in demand for the support of ECAs in response to the financial and economic crisis. This resurgence 'emphasised the need to ensure that a level playing field is maintained for exporters competing with official export credit support for overseas sales'.[2157]

2.2. EXPORT CREDIT SUPPORT FOR AGRICULTURAL PRODUCTS

Serious negotiations on disciplining export credit support for agricultural products only emerged during the Uruguay Round (1986-1995). In response to the US and Cairns group demand to phase-out direct export subsidies, the EC advocated for more disciplines on the use of 'indirect' forms of export subsidies such as export credit support. Here, the EC particularly targeted the US, because it had extensive export credit support programmes in place in which exports were indirectly subsidized.[2158] Therefore, the EC proposed that the OECD Arrangement would be extended to agricultural products and be made applicable in the GATT framework in order to all exporting countries to be bound.[2159] This call for stricter disciplines on export credit support was not only supported by the Cairns group but apparently by the US as well, at least on paper. After all, the US formally proposed that export credit support for agricultural products would be subject to the same disciplines as those elaborated for non-agricultural support (Illustrative List).[2160] Part V of the Agreement on Agriculture reflects the

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[2154] Noteworthy, the January 2009 version provided a temporary relaxation (until 31 January 2010) on the share of participation of export credit support in intra-OECD project finance transactions (50% instead of 35%). This aimed at contributing to the stimulus plans in OECD countries.

[2155] Brazil is Participant to the Sector Understanding for Civil Aircraft, which is annexed to the OECD Arrangement.

[2156] See below n 2173.

[2157] OECD Export Credit Division, *New Measures to Expand the Risk Pricing Disciplines of the Arrangement on Officially Supported Export credits* (10 February 2010).

[2158] Next to food aid policies, Stewart pointed *inter alia* to the US credit guarantees scheme, which 'in intent if not in form' is 'similar to the export subsidies offered by the EC and other countries'. T. P. Stewart (ed), *The GATT Uruguay Round – A Negotiating History (1986–1992) – Volume 1* (Deventer: Kluwer, 1993), 1382 pp., at 145.

[2159] Negotiating Group on Agriculture, *Submission by the European Communities, Improving the GATT Rules and Disciplines* (MTN.GNG/NG5/W/106, 26 September 1989). According to the EC, this would imply *inter alia* that the repayment term for exports of agricultural products would not exceed 180 days and that official support to the interest rate would not be provided. *Note by the Secretariat, Clarification and Elaboration of Elements of Detailed Proposals Submitted Pursuant to the Mid-term Review Decision* (MTN.GNG/NG5/W/161, 4 April 1990), at 77.

[2160] The Cairns Group called for phasing-out all subsidized export credits. Note by the Secretariat, above n 2159, at 66 and 71.

final bargain on export subsidies and identifies six types of export subsidies that are subjected to reduction commitments (Article 9 of the Agreement on Agriculture).[2161] However, export credit support is not included in this list. Only Article 10.2 of the Agreement on Agriculture expressly refers to export credit practices and instructs WTO Members 'to work toward the development of internationally agreed disciplines'. In 1997, this negotiating mandate was picked up by the OECD Arrangement Participants (and Argentina). [2162] Yet, these negotiations under the auspices of the OECD broke down in 2000 and were passed on to the WTO, where they are now continued in the Doha Round negotiations. The latest negotiation results are elaborated in the Revised Draft Modalities for Agriculture (December 2008). This would add an annex (Annex J) on agricultural export credit support to the Agreement on Agriculture.[2163] Before taking a closer look at this text and its negotiating history, the existing disciplines on agricultural as well as non-agricultural export credit support are scrutinized. Note already that the 2001 OECD study as well as certain scholars assumed that, pursuant to Article 10.2 of the Agreement on Agriculture, no international disciplines on agricultural products were in place at the time the Doha negotiations started.[2164] Although in *US – Upland Cotton* this interpretation was fiercely advocated by the US, the Panel and Appellate Body disagreed. Undeniably, the outcome of this case has fundamentally altered the dynamics of the negotiations on agricultural export credit support in the Doha Round.

[2161] See above Part II, Chapter 6, Section 6.2.1.2.1.
[2162] Technical discussions already started in 1995. Export Credits Secretariat, above n 2033. The final negotiating draft circulated was: *The Chairman's Revised Proposal for a Sector Understanding on Export Credits for Agricultural Products* (TD/CONSENSUS(2000)25/REV4, 9 July 2002). See also *Background Paper by the Secretariat, Export Credits and Related Facilities* (G/AG/NG/S/13, 26 June 2000), para. 43.
[2163] See Revised Draft Modalities for Agriculture (TN/AG/W/4/Rev.4, 6 December 2008).
[2164] OECD, above n 2090, at 8. According to Beierle as well, the US managed to avoid WTO disciplines on export credits in the Uruguay Round. T. C. Beierle, 'Agricultural Trade Liberalization – Uruguay, Doha, and Beyond', 36:6 *Journal of World Trade* (2002), 1089-1110, at 1097; S. F. Olsen, 'The Negotiation of the Agreement on Agriculture', in B. O'Conner (ed), *Agriculture in WTO Law* (London: Cameron May, 2005), 43-82, at 78. On the other hand, the WTO Secretariat considered that agricultural export credit support was subject to disciplines in case offered at subsidized terms. Background Paper by the Secretariat, above n 2162, para 44.

3. MAIN ELEMENTS OF THE OECD ARRANGEMENT

The OECD Arrangement 'seeks to foster a level playing field for official support (…) in order to encourage competition among exporters based on quality and price of goods and services exported rather than on the most favourable officially supported financial terms and conditions'.[2165] To this end, disciplines are developed on official support provided by or on behalf of a government for exports of goods (except for agricultural and military products) and/or services that have a repayment period of two or more years.[2166] As indicated, two types of official support are distinguished: export credit guarantee or insurance (pure cover support) and official financing support (direct credit, refinancing, and interest rate support).

Three broad sets of substantive conditions can be distinguished.[2167] First, all forms of officially supported export credits are subject to repayment requirements.[2168] For instance, governments may only provide pure cover support for privately extended export credits that respect these repayment requirements. Second, Participants offering official *financing* support for fixed rate loans (e.g., by providing direct credits or interest rate support mechanisms) have to apply the relevant Commercial Interest Reference Rate (CIRR) as minimum interest rate.[2169] In contrast, Participants are thus allowed to provide pure cover support to export credits extended by private actors with interest rates below the CIRR.[2170] CIRRs should represent final commercial lending interest rates in the domestic market of the currency concerned and closely correspond to the rate for first-class domestic borrowers.[2171] Therefore, the interest rate should be fixed at minimum the CIRR level applicable at the time of authorization. Third, since the Knaepen Package (1999), Participants are obliged to charge premium to cover the risk of non-payment of export credits (credit risk). This premium

[2165] Article 1 of the OECD Arrangement.
[2166] The OECD Arrangement elaborates on disciplines on tied aid as well, but these are not discussed in this Part.
[2167] Specific sector understandings are elaborated for ships, nuclear power plants, civil aircraft, and renewable energies, and water projects.
[2168] For example, minimum down payment, maximum repayment terms, or frequency of repayment (Articles 10-14 of the OECD Arrangement). Repayment terms depend on the country of destination.
[2169] Article 19(a) of the OECD Arrangement.
[2170] In this respect, the Appellate Body's holding in *Brazil – Aircraft* that '(t)he OECD Arrangement establishes minimum interest rate guidelines for export credits supported by its participants ("officially-supported export credits")' is overly broad. After all, export credits receiving pure cover support are not subject to the minimum interest rate provisions. Appellate Body Report, *Brazil – Aircraft*, para 181. In contrast, the Panel in *Brazil – Aircraft (Article 21.5 – Canada)* correctly interpreted the scope of the OECD Arrangement. Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, footnote 68.
[2171] Articles 19-22 of the OECD Arrangement. Each Participant is allowed to establish a CIRR for its national currency, set at 100 basis points above the relevant government bond yields (depending on the maturity). Other Participants have to use this CIRR in case they decide to finance in that currency. A (non-)Participant may request for a CIRR to be established for the currency of a non-Participant. Therefore, the relevant CIRR does not depend on the country providing the export credit support, but corresponds to the currency and maturity of the operation.

should be risk-based and may not be inadequate to cover long-term operating costs and losses.[2172] In particular, Participants are obliged to charge no less than the Minimum Premium Rates (MPRs), which are defined as minimum rates for country credit risk, irrespective of whether the buyer/borrower is a private or public entity. Hence, MPRs form the floor rates that must be respected whenever country risk (i.e., sovereign risk) and/or buyer/borrower risk (i.e., non-sovereign risk) is covered, even though MPRs are currently only based on the country credit risk.[2173] In order to establish MPRs, countries are classified into one of eight Country Risk Categories, based on the likelihood that it will service its external debt.[2174] Premiums do not only apply to pure cover support but also have to be charged in addition to the interest rate (CIRR) in case of official financial support covering country and/or buyer risk.[2175]

[2172] If both conditions are fulfilled, premium rates should normally converge over time. The specific rules on premiums, including the MPRs, do not apply to several transactions covered under sectoral understandings (e.g., ships). Article 23 of the OECD Arrangement; OECD Trade Directorate, above n 2151, at 3.

[2173] Country credit risk relates to the likelihood of whether a country will service its external debt and consists of five elements spelled out in Article 25 of the OECD Arrangement (e.g., general moratorium by the buyer's government, political events arising outside the country of the notifying Member). Types of credit risk not listed in Article 25 of the OECD Arrangement are considered part of the buyer/borrower risk. If official support only covers country credit risk, the MPR is reduced by 10% (Article 24(g) of the OECD Arrangement). On the other hand, if buyer/borrower risk is also covered, the MPR represents the floor rate, even though it does not reflect the risk related to the buyer/borrower that the export credit will not be repaid. Hence, official support covering both country risk and buyer/borrower risk merely has to respect the MPR, subject to the general obligation to cover long-term operating costs and losses. To counter competition among ECAs on the fee level for covering buyer/borrower risk, OECD Participants recently agreed that a premium for buyer risk will be added on top of the premium for country risk when buyer risk is covered. Moreover, they agreed to revise the MPRs. Both modifications will be implemented by September 2011.

[2174] Because countries in category 'zero' (high income) are considered to have a negligible country risk, no MPRs exist but governments are not allowed to 'charge premium rates which undercut available private market pricing'. On the other hand, the highest risk countries (category 7) 'shall, in principle, be subject to premium rates in excess of the MPRs established for that country'. Yet, it is left to the Participants to determine this surplus, again subjected to the general obligation to cover long-term operating costs. See Article 24 of the OECD Arrangement; OECD Trade Directorate, above n 2151, at 3.

[2175] In case of interest rate support, this might not always be required in practice, because repayment risks are often not covered when interest rate support is offered. As such support was not explicitly listed among the other types of support in the provision requiring MPRs, the Panel in *Brazil – Aircraft (Article 21.5 – Canada II)* concluded that interest rate support falls outside the category for which a premium is to be charged insofar it is not given in conjunction with pure cover support. The Panel observed that there is no need to charge a premium since, by extending interest rate support, governments do not assume credit risk. Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, para 5.171. Under the current version of the OECD Arrangement, the types of export credit support for which MPRs have to be charged are no longer listed, as it more broadly requires OECD Participants to 'charge premium, in addition to interest charges**,** to cover the risk of non-repayment of export credits' (Article 23 OECD Arrangement). Although the textual basis for excluding interest rate support is thus deleted, it is still the case that no MPRs have to be charged in case governments do not assume repayment risks when providing such support.

If a Participant applies an exception to these obligations, this has to be notified and other Participants are allowed to match this offer.[2176] This 'notice and match' principle probably explains part of the success of the OECD Arrangement in limiting the export credit support contest among its Participants.[2177] The OECD Arrangement's compliance mechanism thus works on the basis of a tit-for-tat strategy.[2178] Cooperative behavior is achieved without legal enforcement mechanism, but could equally not be reached without the OECD Arrangement. Next to the lack of knowledge on what the rules of the game should look like, there would indeed be no transparency on the offers made by other ECAs without this 'gentlemen's agreement'.

The OECD Arrangement also explains why pure cover support has become the dominant form of export credit support over the years.[2179] Because the level of market interest rates on a floating rate basis has typically undercut the CIRR level over the last decade, fixed rate official financing support was not an attractive trade finance instrument. In contrast, pure cover support (i.e., guarantees or insurance) to export credits extended by private actors could result in interest rates well below CIRR levels without violating the OECD Arrangement.[2180] Yet, according to a report of the US Ex-Im Bank, the deterioration of the trade financing market resulting from the financial and economic crisis might revive exporters' interest in official financing support. First, commercial banks have been reluctant to offer export credits even with ECAs pure cover backing. Second, those exporters still able to borrow on the private market might also opt for secure fixed rate official financing support at CIRR levels that are relatively low because of expansionary monetary policies.[2181]

[2176] Other Participants also have this right to match in case another Participant *deviates* from the OECD Arrangement. Likewise, financial conditions offered by non-Participants could be matched. Articles 18 and 40-45 of the OECD Arrangement.
[2177] See Mendelowitz, above n 2121, at 162.
[2178] An ECA will follow the strategy of offering OECD Arrangement-conform support as long as other ECAs also follow this strategy. As soon as another ECA ('initiating Participant') offers support at more flexible terms, other ECAs are allowed to match this offer, which will cancel out the competitive advantage of the initial support.
[2179] The US Ex-Im Bank also refers to lower administrative costs and balance sheet treatment of pure cover support. See Export-Import Bank of the United States, above n 2045, at 94.
[2180] The OECD Arrangement does not ensure that this interest rate benefit is compensated by the premium charged for such support, given that the minimum premium levels set under the OECD Arrangement when covering buyer/borrower risk are certainly better than those available on the market (see above n 2175).
[2181] This call for official financing support might put ECAs who only have medium- and long-term pure cover support programmes in place at a disadvantage vis-à-vis other ECAs. See Export-Import Bank of the United States, above n 2045, at 19-24, 94-95.

4. DISCIPLINES ON EXPORT CREDIT SUPPORT FOR NON-AGRICULTURAL PRODUCTS

4.1. IDENTIFICATION OF THE CLAIM MADE AGAINST EXPORT CREDIT SUPPORT: 'AS SUCH' VERSUS 'AS APPLIED' CLAIMS

Before entering into the analysis of disciplines on export credit support under the SCM Agreement, it should be clarified what type of support measure could exactly be challenged and how such a claim should be formulated. In this respect, scholars have observed that panels in the context of the SCM Agreement applied the 'controversial'[2182] mandatory/discretionary distinction that was developed in the GATT jurisprudence.[2183] Mandatory measures are measures which would require the government to act in a WTO-inconsistent way, whereas discretionary measures leave the government the possibility to apply these measures in a WTO-consistent manner. Discretionary measures can therefore not be challenged *as such*. Only their application (*as applied*) could be found WTO-inconsistent. In contrast, an *as such* challenge of a measure has to establish that the measure on 'its face', regardless of its application, requires the government to act in a WTO-inconsistent manner.[2184] Hence, the mandatory/discretionary distinction sets a high standard for challenging measures of general application. The rationale underlying this distinction is that the executive branch should be presumed to act in good faith in the sense that it will apply discretionary measures in a WTO-consistent manner. Nonetheless, a close look at the case law on export credit support will show that panels did not apply the mandatory/discretionary principle systematically. This overview will equally introduce the most relevant cases which dealt with export credit support on non-agricultural products.

First of all, the mandatory/discretionary distinction was at the core of the discussion in the trade dispute between Brazil and Canada on export credit support given to their domestic regional aircraft industry (Embraer and Bombardier, respectively) that resulted in mutual claims before the WTO. In *Canada – Aircraft*, Brazil challenged debt financing and loan guarantees provided by the Export Development Corporation (EDC) under its Corporate

[2182] Panel Report, *US – Customs Bond Directive*, para 7.208. The Panel also gives an indication of the stance of the panels and the Appellate Body on this principle anno 2008 (paras 7.198-7.214).

[2183] See GATT Panel Report, *US – Tobacco*, para 118. See A. Green, M. Trebilcock, and V. Milat, 'The Enduring Problem of WTO Export Subsidies Rules', *Draft Working Paper* (April 2007), 61 pp., at 27-31. For a somewhat outdated discussion on the application of this distinction under the WTO, see S. Bhuiyan, 'Mandatory and Discretionary Legislation: The Continued Relevance of the Distinction under the WTO', 5:3 *Journal of International Economic Law* (2002), 571-604; K. Kiat Sim, 'Rethinking the mandatory/discretionary legislation distinction in WTO jurisprudence', 2:1 *World Trade Review* (2003), 33-62.

[2184] Panel Report, *Canada – Aircraft*, para 7.83; Panel Report, *Canada – Aircraft Credits and Guarantees,* para 7.83. By definition, the discretionary/mandatory distinction can only be applied to measures of general application, such as legislation setting up an ECA or elaborating an export credit support programme, contrasting measures of individual application, such as a specific export credit support transaction.

Account.[2185] Under the debt financing component, EDC provided loans directly to buyers of Canadian regional aircrafts ('direct credit'). The loan guarantees to buyers of Canadian regional aircrafts are a type of 'pure cover' export credit support. Other challenges relevant to the export credit discussion were support extended to the civil aircraft industry by the Canada Account, also part of EDC, as well as funds provided to the civil aircraft industry by the Technology Partnerships Canada (TPC).[2186]

In challenging this export credit support, Brazil formulated, first of all, a claim against EDC *as such* because its mandate of 'supporting and developing, directly or indirectly, Canada's export trade' requires EDC to offer Canadian exporters funding schemes at below market terms. Yet, the Panel disagreed because 'a mandate to support and develop Canada's export trade does not amount to a mandate to grant subsidies, since such support and development could be provided in a broad variety of ways'.[2187] On the other hand, the Panel agreed with Brazil that Canada's export credit support *as applied* in the regional aircraft sector was inconsistent with the SCM Agreement.[2188]

Could Canada simply withdraw these particular export subsidies in order to bring its measure into compliance with the requirement to withdraw the subsidy without delay (Article 4.7 SCM Agreement), given that the application of these programmes in the context of regional aircrafts were found a prohibited subsidy? Remarkably, the Panel's compliance proceedings (*Canada–Aircraft (Article 21.5 – Brazil)*) set a much higher standard for Canada to conform to. Indeed, the proceedings examined whether Canada's implementation measure (i.e., the Policy Guideline) 'ensures' that prohibited subsidies ceased to exist under the Canada Account.[2189] In its assessment of the Canada Account, which is 'by definition forward-looking', the Panel examined whether 'the Policy Guideline is sufficient to *ensure* that in future this programme, as it *will be applied*, will not provide prohibited export subsidies to the regional aircraft

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[2185] EDC also offered residual value guarantees to lessors as well as equity financing, but the evaluation of these claims is not relevant for the export credit discussion.

[2186] Other measures challenged by Brazil in this case are not elaborated because they do not relate to export credit support. See Panel Report, *Canada – Aircraft*, above n 2184, para 2.2

[2187] Panel Report, *Canada – Aircraft*, above n 2184, para 9.127. In addition, a separated *as such* claim was also made against the Canada Account programme. Yet, the Panel rejected this claim as well, because it did not mandate export subsidies but constituted discretionary legislation. In the words of Brazil, the Canada Account funds are 'used to support export transactions which the federal government deems to be in the national interest but which, for reasons of size or risk, the Export Development Corporation (EDC) cannot support through regular export credits'. Canada indicated that the Canada Account is part of the EDC. Panel Report, *Canada – Aircraft*, above n 2184, paras 9.211-9.213.

[2188] In contrast, the Panel concluded that Brazil failed to make a *prima facie* case against the EDC *as applied* (EDC debt financing, EDC loan guarantees, EDC residual value guarantees, and EDC equity financing). Panel Report, *Canada – Aircraft*, above n 2184, paras 9.131 – 9.203.

[2189] Panel Report, *Canada – Aircraft (Article 21.5 – Brazil)*,,para 5.65. The Panel argued that both parties agreed with this standard. The same standard was elaborated for the revised TPC programme (paras 5.09-5.12).

industry'.[2190] This Panel apparently elaborated exactly the opposite standard to review Canada's implementation than the one usually applied to other *as such* claims: the Canada Account programme complies with the original ruling only if it cannot be applied in a WTO-*in*consistent manner, whereas measures of general application can traditionally only be challenged if they cannot be applied in a WTO-consistent way. This line of (inductive) reasoning means that a WTO Member could challenge an export credit programme *as applied* in specific transactions and that, in order to bring this measure into compliance, the violating Member would have to ensure in its legislation that its programme could not be applied in a WTO inconsistent manner in the future. The implementation of an *as applied* finding would mandate a revised programme that, as such, could never be applied in a WTO-inconsistent manner. Yet, until now, this demanding implementation standard for prohibited subsidies was not confirmed by other panels nor by the Appellate Body. To the contrary, the Appellate Body in the appeal compliance proceedings warned that the 'ensure in the future'-standard 'should be viewed with caution' because 'if taken too literally, (it) might be read to mean that the Panel was seeking a strict guarantee or absolute assurance as to the *future* application of the revised TPC programme'.[2191] This standard, the Appellate Body continued, 'would be very difficult, if not impossible, to satisfy since no one can predict how unknown administrators would apply, in the unknowable future, even the most conscientiously crafted compliance measure'.[2192]

In its counterclaim (*Brazil – Aircraft*), Canada challenged payments for the export of regional aircrafts made by the Programa de Financiamento às Exportações (PROEX), an export financing programme administered by a committee within the Brazilian government.[2193] Under the 'Interest Equalization' component, PROEX granted the lending financial institution an equalization payment to cover, at most, the difference between the interest charges contracted with the buyer and the cost to the financing party of raising the required funds.[2194] Such interest rate support was requested to PROEX by the Brazilian manufacturer of regional aircrafts (in casu, 'Embraer', which was the only one) prior to the formal agreement with the

[2190] Emphasis added. Panel Report, *Canada – Aircraft (Article 21.5 – Brazil),* para 5.66. The simple absence of new Canada Account transactions to the regional aircraft since adoption of the original Panel report proved thus insufficient to reach a conclusion (see para 5.66). Hence, this was an *as such* claim *par excellence*.

[2191] Emphasis in the original. Only the Panel's holding on the TPC Programme (and not on the Canada Account) was appealed. Appellate Body Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para 38.

[2192] Appellate Body Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para 38.

[2193] See factual background, Panel Report, *Brazil – Aircraft*, paras 2.1-2.6. Day-to-day transactions under PROEX were performed by the 'Banco do Brazil'.

[2194] The payments are made in the form of non-interest bearing National Treasury Bonds that can only be redeemed in Brazil, in Brazilian currency at the exchange rate prevailing at the time of payment. In case the lending bank is outside of Brazil, it may appoint a Brazilian bank as its agent to receive the semi-annual payments on its behalf. PROEX also had a 'direct financing' component, under which PROEX lent a portion of the fund required for the transaction. Yet, this component was not directly challenged by Canada. Panel Report, *Brazil – Aircraft*, paras 2.2 and 3.2.

buyer. Hence, this support was part of the financing package that Embraer was able to offer to potential foreign buyers. PROEX interest equalization payments to the lending bank started after the aircraft was exported and paid for by the purchaser. Therefore, the interest rate support, a form of direct official financing, enabled the lending bank to charge a lower interest rate on the buyer's loan by which the exporter was paid ('buyer credit').[2195]

The Panel, however, observed some lack of clarity on the precise measure being challenged. On the one hand, Canada did not bring a claim against the interest rate equalization component of the PROEX programme 'per se'. On the other hand, Canada's claim included but was not restricted to individual payments and, in the Panel's view, instead referred 'more generally (to) *the practice* involving PROEX payments relating to exported Brazilian regional aircraft (which we will hereafter refer to as "PROEX payments")'.[2196] Therefore, the Panel considered that it had 'to go beyond an examination of individual PROEX payments that have been identified and look more generally at *the nature and operation* of the PROEX interest rate equalization scheme which governs the payment of the alleged export subsidies'.[2197] Implicitly and apparently unnoticed by later panels and observers, the Panel seemed to have avoided the strict mandatory/discretionary distinction. It examined *the nature and operation* of the PROEX interest rate equalization scheme with respect to regional aircrafts to determine whether this *practice* was WTO-consistent. In contrast to traditional *as such* claims, it was not examined whether the scheme 'an sich' mandated the provision of WTO-inconsistent export subsidies.[2198] Hereto, the operation of the scheme in individual cases related to regional aircrafts (resulting in an undefined 'practice') was considered relevant.[2199] In contrast to *as applied* claims, the examination of the Panel was not restricted to individual payments identified by Canada.[2200] Its findings generally stated that 'payments on exports of

[2195] See Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, footnote 141.

[2196] Emphasis added. Panel Report, *Brazil – Aircraft*, para 7.2. The Panel observed and emphasized that Canada held that 'all PROEX payments, to the extent they relate to exported Brazilian regional aircraft, *including payments to be made in the future pursuant to the PROEX interest rate equalization scheme,* are prohibited subsidies' (emphasis in the original). Strictly speaking, this allegation could only be proven if the PROEX interest rate equalization scheme mandated the payment of prohibited subsidies (i.e., if it left no option under the scheme to make future payments WTO-consistent). However, the Panel did not articulate the strict mandatory/discretionary principle.

[2197] Emphasis added. Panel Report, *Brazil – Aircraft*, para 7.2.

[2198] The Panel did not articulate that Canada had to make a *prima facie* case that the scheme mandated (regardless of individual applications) the provision of WTO-inconsistent subsidies. To be sure, the Panel seemed to consider that subsidization as well as an application inconsistent with item (k), para 1 Illustrative List, was inherent in (and thus mandatory under) the scheme (see below) (Panel Report, *Brazil – Aircraft*, para 7.34, in fine).

[2199] For example, Panel Report, *Brazil – Aircraft*, para 7.36.

[2200] In the words of the Panel, 'the payments subject to challenge in this dispute include, but are not limited to, PROEX payments made or to be made with respect to the transactions identified (by Canada)'. Panel Report, *Brazil –* Aircraft, para 7.3.

regional aircraft under the PROEX interest rate equalization scheme are export subsidies inconsistent with Article 3 of the SCM Agreement'.[2201]

In order to comply with this ruling, Brazil specified in its legislation a minimum interest rate (the US Treasury Bond 10-year rate, plus an additional spread of 0.2%) for export credits supported by interest equalization payments (PROEX II), which was again challenged by Canada.[2202] Brazil conceded that these payments were export subsidies, but argued that payments resulting in the minimum interest rate where not used to secure material advantage and were therefore justified on the basis of para 1 of item (k) of the Illustrative List. However, the Panel and the Appellate Body considered the minimum interest rate not to be an appropriate market benchmark and therefore not in accordance with para 1 of item (k).[2203] Again, the mandatory/discretionary distinction was not addressed (and was not raised by Brazil), though strictly speaking Brazil's legislation did not mandate the provision of interest equalization payments that resulted in the *minimum* interest rate and thus did not seem to *as such* violate the SCM Agreement.[2204]

On the other hand, the Panel in the second compliance proceedings (*Brazil – Aircraft (Article 21.5 – Canada II)*) rigorously applied the mandatory/discretionary distinction in its examination of PROEX III, by which Brazil attempted to comply with the first compliance proceedings but which was once more challenged by Canada.[2205] The Panel also clarified that the mandatory/discretionary distinction is applicable in the context of an affirmative defence under the second paragraph of item (k)[2206] and found that Canada only articulated an *as such* claim against PROEX III (insofar it related to regional aircrafts), as PROEX III was not yet applied in practice. Taking into account that Brazil based its affirmative defence on paragraph 2 of item (k), the relevant question was thus whether PROEX III *required* the Brazilian executive branch to provide (i) export subsidies (ii) that were inconsistent with the interest rate provisions of the OECD Arrangement. Similar to PROEX II, PROEX III also set a *minimum* interest rate for export credits supported by interest equalization payments, which now referred to the CIRR, and considered financing terms practiced in the international

[2201] Panel Report, *Brazil – Aircraft*, para 8.2.

[2202] The legislation specified that in 'the financing of aircraft exports for regional aviation markets, equalisation rates shall be established on *a case by case* basis and at levels that may be differential, *preferably* based on the US Treasury Bond 10-year rate, plus an additional spread of 0.2% per annum, to be reviewed periodically in accordance with market practices'. See Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para 6.19.

[2203] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para 6.104; Appellate Body Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para 76. As will be elaborated below, the Panel and Appellate Body reached this conclusion on somewhat different grounds.

[2204] The parties and the Panel did not disagree that these were *minimum* interest rates (which is also apparent from the legislation, see above n 2202). Hence, Brazil could have argued the legislation did not mandate support up to level of this *minimum* interest rate.

[2205] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, paras 5.51-5.55.

[2206] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, paras 5.162-5.168.

market as well. Although it observed that the application of these benchmarks would not preclude (even to the contrary, it would most likely confer[2207]) a benefit on the exporter of regional aircrafts, the Panel concluded that PROEX III was not an export subsidy because it gave the executive branch discretion not to confer such benefit.[2208] Refraining from exercising judicial economy, the Panel additionally found that PROEX III did *allow* Brazil to act in conformity with the interest rates provisions of the 1998 OECD Arrangement.[2209] Consequently, Canada's claim that PROEX III violated Article 3.1(a) of the SCM Agreement was not upheld. In applying the mandatory/discretionary standard, this Panel gave much more leeway to the implementing WTO Member than the Panel in *Canada–Aircraft (Article 21.5 – Brazil)* which adopted the 'ensure in the future'-standard.[2210] Interestingly, the Panel also acknowledged that another Panel (*US – Section 301 Trade Act*) had recently concluded that even discretionary legislation could violate certain WTO obligations. However, it did not similarly lower the threshold to challenge legislation since, in contrast to the relevant provision in *US – Section 301 Trade Act*,[2211] Article 3.1(a) of the SCM Agreement does not prohibit legislation 'that would permit, but not require, the grant of prohibited subsidies'.[2212]

[2207] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, para 5.93.

[2208] The financial contribution and export contingency elements of PROEX III payments were not disputed. The Panel elaborated on the high threshold for an *as such* claim: 'a conclusion that PROEX III *could* be applied in a manner which confers a benefit, or even that it was intended to be and *most likely would* be applied in such a manner, would not be a sufficient basis to conclude that PROEX III as such is mandatory legislation susceptible of inconsistency with Article 3.1(a) of the *SCM Agreement*' (emphasis in the original). Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, paras 5.85 and 5.97. Arguably, discretion to apply the export credit programme in a WTO-compatible way was also available under PROEX II (e.g., application on a case-by-case basis) but, as mentioned, the Panel did not specify this high threshold in the first compliance proceedings. The fact that the minimum interest rate was higher under PROEX III and referred to the CIRR (in line with the safe haven) probably inspired the Panel in the second compliance proceedings to articulate the higher threshold for challenging measures of general application. 'Even if Canada were correct that BCB Resolution 2799 did not *require* that net interest rates supported by PROEX III be at or above the CIRR, it certainly *envisions* that they will be. Thus, we cannot say that PROEX III does not *allow* compliance with (the minimum interest rate provision of the OECD Arrangement)'. Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, para 5.184 (emphasis in the original).

[2209] Put otherwise, PROEX III did not require Brazil to act in a manner that is not consistent with the 1998 OECD Arrangement. See Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, paras 5.168 and 5.250. Statements by Brazil referred to by Canada which indicated that PROEX III would be applied inconsistent with the 'safe haven' could not alter this conclusion because they do not legally commit Brazil to apply PROEX III in a WTO inconsistent manner. Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, para 5.231.

[2210] Three elements explained this different approach: (i) Parties did not agree to use this 'ensure in the future'-standard; (ii) the Appellate Body expressed some 'discomfort' with this standard; and (iii) in contrast to the case before the Panel, the Panel in *Canada – Aircraft (Article 21.5 – Brazil)* was reviewing a subsidy programme *as applied* and not a subsidy programme as such. Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, footnote 130. However, some doubts might be expressed on the third element given that the Panel in the *Canada – Aircraft (Article 21.5 – Brazil)* case was indeed reviewing the implementation of an *as applied* inconsistency but examined the programme *as such*.

[2211] This provision was Article 23 of the Dispute Settlement Understanding (DSU), which in itself prohibits some legislative discretion. This Panel explicitly noticed that its reasoning did 'not imply a reversal of the classical test in the pre-existing jurisprudence that only legislation mandating a WTO

In *Canada – Aircraft Credits and Guarantees*, Brazil again challenged similar export credits offered by Canada to its regional aircraft industry.[2213] In particular, Brazil formulated a similar *as such* claim against EDC Corporate and Canada Accounts because they 'are established and operate as [ECAs] that have as the *raison d'être* of their existence the provision of export subsidies'.[2214] ECAs have a competitive advantage over the private sector (e.g., because ECAs do not pay taxes), enabling them to offer more favourable terms than the private sector. Moreover, there would be no need for the EDC if it did not offer support on more favourable terms than the market. Applying the mandatory/discretionary distinction, the Panel, however, disagreed since the fact that ECAs may have a competitive advantage 'that *allows* them to undercut private sector competitors does not mean that they are necessarily *required* to do so'.[2215] Accordingly, the Panel rejected the *as such* claim as the EDC does not – by virtue of being an ECA – mandates subsidization.[2216] An ECA is thus not in itself – *as such* – inconsistent with the SCM Agreement.[2217] Again, the relaxation elaborated in *US – Section 301 Trade Act* was not adopted, because a different legal issue was at stake (i.e., Dispute Settlement Understanding or DSU) and neither party requested to follow this approach.[2218] In addition, this Panel specified that *as applied* claims should be limited to *specific transactions* undertaken under a programme, because findings regarding a *programme* '*as applied*' would undermine the utility of the mandatory/discretionary distinction.[2219] Pivotal in the Panel's explanation was that an *as applied* claim against a programme could only be upheld if *all* specific transactions under that programme would be WTO-inconsistent (no inductive reasoning).[2220] The Panel thus also disagreed with the reasoning developed by the Panel in *Canada–Aircraft (Article 21.5 – Brazil)* that an *as applied*

inconsistency or precluding WTO consistency, could, as such, violate WTO provisions'. Panel Report, *US – Section 301 Trade Act*, para 7.54.

2212 Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para 5.54.

2213 The Panel disagreed with Canada that this was an implementation question related to the first *Canada – Aircraft* dispute because, according to the Panel, Brazil did not request the Panel to review the implementation, different transactions were at issue which resulted in current violations, and the legal framework had changed under which the Canada Account operated. Panel Report, *Canada – Aircraft Credits and Guarantees,* paras 7.15-7.19.

2214 Including predecessor programmes. Response of Brazil to Question 29 of the Panel, as cited by the Panel in *Canada – Aircraft Credits and Guarantees,* para 7.71.

2215 Emphasis in the original. Panel Report, *Canada – Aircraft Credits and Guarantees,* paras 7.76-7.85.

2216 Panel Report, *Canada – Aircraft Credits and Guarantees*, paras 7.83 and 7.84

2217 Even if the Panel would have upheld that ECAs mandate subsidization, the Panel would still have had to reject the *as such* claim because ECAs certainly do not mandate subsidization inconsistent with the SCM Agreement given the 'safe haven' provided in item (k) of the Illustrative List and the other exceptions (for developing countries and agricultural export credits).

2218 Panel Report, *Canada – Aircraft Credits and Guarantees*, footnote 36.

2219 Panel Report, *Canada – Aircraft Credits and Guarantees,* paras 7.15-7.19.

2220 An additional *as applied* determination of the programme would therefore have no added value since the obligations for implementation would not extend beyond those specific transactions. In contrast, it would be inappropriate for a Panel to determine that a programme *as applied* is inconsistent on the basis that certain – but not all – specific transactions under the programme are inconsistent because the implications for implementation would be extended beyond those specific inconsistent transactions.

finding would imply that a Member should ensure against future exercises of discretion in violation of the SCM Agreement.[2221] In sum, the Panel in *Canada – Aircraft Credits and Guarantees* emphasized the distinction between *as such* and *as applied* claims: general measures (e.g., programmes) can only be challenged *as such* and should thus mandate WTO-inconsistent implementation, in contrast to *as applied* claims that can only be made on the level of individual transactions. In this respect, one specific relaxation seemed to be accepted on the strict mandatory/discretionary distinction, namely in cases 'where a Member's discretionary legislation has functionally become mandatory as a result of that Member exercising its discretion under that legislation in such a manner that it has become legally bound to continue to exercise its discretion in that manner in the future'.[2222]

Next to the Brazil versus Canada dispute on export credits for regional aircrafts, the Panel decision in *Korea – Commercial Vessels* sheds light on the provisions related to export credits in the SCM Agreement. In this case, the EC challenged, *inter alia*, pre-shipment loans (PSL) and advance payment refund guarantees (APRG) offered by the Export-Import Bank of Korea (KEXIM) to Korean shipyards. The EC formulated *as such* claims against KEXIM's legal regime, the PSL programme as well as the APRG programmes, and *as applied* claims against individual transactions under both programmes. In reviewing the *as such* claims, the Panel once more applied the mandatory/discretionary distinction even though, at that time, the Appellate Body in *US – Corrosion-Resistant Steel Sunset Review*[2223] had already questioned two different aspects of this 'analytical tool'.[2224] First, the Appellate Body had concluded that there was 'no reason for concluding that, in principle, non-mandatory measures cannot be *challenged* 'as such'' but this statement related, as the Panel in *Korea – Commercial Vessels* correctly observed, to a jurisdictional matter.[2225] Hereby, the Appellate Body expressed that Panels are not 'obliged, as a preliminary jurisdictional matter, to examine whether the challenged measure is mandatory', which is 'relevant, if at all, only as part of the panel's assessment of whether the measure is, as such, inconsistent with particular obligations'.[2226] Second, on the latter aspect, the Appellate Body, refraining from undertaking a 'comprehensive examination of this distinction' [2227] nevertheless observed that the 'import of

[2221] The Panel hereby also noticed the doubts expressed by the Appellate Body in *Canada – Aircraft (Article 21.5 – Brazil)* on this 'ensure in the future'-standard.
[2222] Panel Report, *Canada – Aircraft Credits and Guarantees,* footnote 93.
[2223] Appellate Body Report, *US – Corrosion-Resistant Steel Sunset Review*, para 93.
[2224] This Panel, again, cited the Appellate Body's doubts with the 'ensure in the future'-standard elaborated by the Panel in *Canada – Aircraft (Article 21.5 – Brazil)*. Panel Report, *Korea – Commercial Vessels*, para 7.95.
[2225] Emphasis added. Appellate Body Report, *US – Corrosion-Resistant Steel Sunset Review*, para 88.
[2226] Appellate Body Report, *US – Corrosion-Resistant Steel Sunset Review*, para 89.
[2227] Previous panels acknowledged that the Appellate Body did not generally express its opinion on the relevance of this distinction so far, but nonetheless found implicit support in several Appellate Body

the "mandatory/discretionary distinction" may vary from case to case' and therefore cautioned against 'the application of this distinction in a mechanistic fashion'.[2228] Yet, the Panel in *Korea – Commercial Vessels* reasoned that the Appellate Body still applied the traditional mandatory/discretionary distinction.[2229] On the other hand, the Appellate Body in *US – Zeroing (EC)*, relied on this particular statement in *US – Corrosion-Resistant Steel Sunset Review* to support its view that the Panel was not required to apply the mandatory/discretionary distinction in analyzing *as such* claims under the relevant provisions of the Anti-Dumping Agreement because it took into account all of the evidence placed before it and sought verification of its accuracy.[2230]

In conclusion, the approach taken so far by panels on the mandatory/discretionary distinction in reviewing claims under SCM Agreement in general, and on export credits in particular, is far from uniform. The Appellate Body's holdings made in the context of the Anti-Dumping Agreement in *US – Corrosion-Resistant Steel Sunset Review* and *US – Zeroing (EC)* might give some relevant guidance to future panels. The Appellate Body rightly seemed to criticise that the traditional mandatory/discretionary theory blurs the distinction between a preliminary jurisdictional question (what can be challenged?) and the substantive scrutiny of the measure in light of WTO obligations (is the measure WTO-consistent?).[2231] So, the Appellate Body made a helpful distinction between a jurisdictional and substantive question.

First, the *jurisdictional question* examines what type of measures can be challenged *as such*. The Appellate Body in *US – Zeroing (EC)* clarified that the complaining party bringing an *as such* claim 'must clearly establish (…) at least that the alleged "rule or norm" is attributable to the responding Member; its precise content; and (…) that it does have general and prospective

holdings (see, for example, Panel Report, *US – Corrosion-Resistant Steel Sunset Review*, para 7.114, footnote 95). In particular, the Appellate Body's reasoning in *US – Oil Country Tubular Goods Sunset Reviews* seemed to be supportive of this distinction: 'By definition, an 'as such' claim challenges laws, regulations, or other instruments of a Member that have general and prospective application, asserting that a Member's conduct – not only in a particular instance that has occurred, but in future situations as well – will *necessarily* be inconsistent with that Member's WTO obligations' (emphasis added). Appellate Body Report, *US – Oil Country Tubular Goods Sunset Reviews*, para 172.

[2228] Appellate Body Report, *US – Corrosion-Resistant Steel Sunset Review*, para 93.

[2229] The Panel emphasized that the Appellate Body explicitly confirmed the rationale behind this distinction by stating that 'where discretionary authority is vested in the executive branch of a WTO Member, it cannot be assumed that the WTO Member will fail to implement its obligations under the WTO Agreement in good faith'. Panel Report, *Korea – Commercial Vessels*, paras 7.62-7.63.

[2230] Appellate Body Report, *US – Zeroing (EC)*, paras 213-214.

[2231] See Appellate Body Report, *US – Corrosion-Resistant Steel Sunset Review*, para 93. Indeed, under the traditional mandatory/discretionary distinction, general measures can thus be *challenged as such* or *as applied*, but the *as such* claim will only be *upheld* if the measure cannot be applied in a WTO-consistent way. This distinction thus already requires a scrutiny of the measure under the relevant WTO provisions: mandatory measures are measures which cannot be applied WTO-consistent (even though they might give discretion to the government but none of the options is WTO-consistent). A measure is labelled 'mandatory' after scrutiny of the measure (regardless of its actual application) under the relevant WTO provision. Mandatory measures are thus *by definition* WTO inconsistent.

application'.[2232] The complaining party should put forward sufficient evidence on these three elements, which may 'include proof of the *systematic application* of the challenged "rule or norm"'.[2233] Importantly, the Appellate Body thus seems to uphold the relevance of the distinction between *as such* and *as applied* claims. It recalled the seriousness of the former claim because, as it had stated in *US – Oil Country Tubular Goods Sunset Reviews,* '(i)n essence, complaining parties bringing *as such* challenges seek to prevent Members *ex ante* from engaging in certain conduct. The implications of such challenges are obviously more far-reaching than *as applied* claims'.[2234] Apparently, the Appellate Body recognized that the implementation of grounded *as applied* claims do not extend beyond the transactions found to be violated.[2235] Indeed, the importance of the distinction of *as applied* and *as such* claims seems to rest on their different obligations for implementation. In this sense, the Panel in *Canada – Aircraft Credits and Guarantees* seemed correct when it argued that *as applied* claims should focus on individual transactions (applications) and, consequently, not on the programme *as applied* because the latter analysis would be *redundant* if all individual applications of that programme are WTO-inconsistent and *inappropriate* in case some – but not all – applications thereof are WTO-inconsistent. In general, an ECA or export credit programme can thus be challenged *as such* as it would meet the three conditions set by the Appellate Body. An analysis on the general application of an export credit programme in a specific sector cannot be made *as applied*, but has to made on the level of specific transactions. On the other hand, such a general application of an export credit programme in a specific sector could be considered a rule or norm that can be challenged *as such* if it is considered a *systematic application*. A systematic application might indicate that this practice, which should have a precise content and would be attributable to the government, does have general and *prospective* application.[2236] But it should be emphasized that the Appellate Body warned that this is a 'high threshold' to meet. Hence, the Appellate Body leaves limited scope for an inductive reasoning in which a finding is made on an aggregate level based on individual applications.

Second, once an *as such* claim against a measure of general and prospective application is accepted, *the substantive question* on whether this measure *as such* violates the WTO

2232 Appellate Body Report, *US – Zeroing (EC)*, para 198.
2233 Emphasis added. Appellate Body Report, *US – Zeroing (EC)*, para 198.
2234 Appellate Body Report, *US – Zeroing (EC)*, para 189.
2235 See also Decision by the Arbitrator, *Canada – Aircraft Credits and Guarantees (Article 22.6 – Canada)*, para 3.110.
2236 Disregarding the fact that the Panel blurred the jurisdictional and substantive question, this seems somewhat in the line with (but clearly less strict than) the abovementioned reservation made by the Panel in *Canada – Aircraft Credits and Guarantees* on the case 'where a Member's discretionary legislation has functionally become mandatory as a result of that Member exercising its discretion under that legislation in such a manner that it has become legally bound to continue to exercise its discretion in that manner in the future' (see above n 2222).

Agreement should be addressed. Unfortunately, the Appellate Body is less clear on the standard for finding a violation. Under the traditional mandatory/discretionary distinction, an *as such* claim would only be upheld if it *mandates* WTO-inconsistent applications. As mentioned above, the Appellate Body held that this distinction may vary from case to case and therefore cautioned against its application in 'a mechanistic fashion'. By calling for a case by case analysis, the Appellate Body seems to indicate that it would not set the standard for *as such* claims as high as under the traditional approach in each and every case but, at the same time, leaves open the possibility that it would apply this standard in some cases. Yet, this call for 'a case by case' analysis provides little guidance on future panels on how to avoid an application in such a mechanistic fashion.

Reading together these substantive and jurisdictional questions, the following analysis could be proposed in scrutinizing a measure under the export subsidy prohibition in the SCM Agreement. First, an *as such* claim can be advanced against a measure that does not derive its general and prospective aspects from its application but from its formulation and its hierarchy in norms (e.g., written law). For example, *the legal framework* spelling out how an ECA or export credit programme will operate and will be applied by the executive branch (e.g., law prescribing that export credits might be based on the CIRR but leaving the final decision to the executive branch).[2237] Here, the traditional mandatory/discretionary test could be applied: a violation would only be found if this legal framework, regardless of its actual application, mandates the provision of prohibited export subsidies. Second, if this legal framework is *systematically applied* in a certain manner, this might be considered a measure of general and prospective application ('practice') that could be challenged *as such* (e.g., exports credits are systematically provided on a CIRR basis). The question is then whether this practice is in accordance with WTO obligations (e.g., are export credits based on the CIRR in conformity prohibited export subsidies?). By definition, the mandatory/discretionary rule, which looks at how the measure will be applied, is not relevant here because a 'practice' is a systematic application in itself. A legal framework that is discretionary but that is systematically applied in a WTO-inconsistent manner could no longer be applied in this way. This could be considered a careful relaxation of the traditional mandatory/discretionary distinction without touching upon its rationale, namely that WTO Members are presumed to implement their laws in a WTO-consistent way. Indeed, in case of a systematic WTO-inconsistent application, the presumption of good faith is not confirmed. Third, if there is no systematic application, only an *as applied* claim can be advanced against *individual applications* of the legal framework. The application in an individual transaction is then examined in light of WTO obligations (e.g., a specific export credit provided on the CIRR level). In sum, the

[2237] See also Panel Report, *US – Customs Bond Directive* paras 7.212-7.213. In order to reveal the exact meaning of the law in question, evidence on the consistent application could be advanced.

more general the claim brought and considered is, the more difficult it will be to upheld it in the end but also the higher the obligations for implementation are.[2238] We now turn to the substantive disciplines on export credit support under the SCM Agreement.

4.2. IS EXPORT CREDIT SUPPORT A SPECIFIC SUBSIDY UNDER THE SCM AGREEMENT?

By virtue of Article 1 of the SCM Agreement, a subsidy is deemed to exist if two distinctive elements are present: (i) a financial contribution by a government[2239] (ii) that confers a benefit[2240]. In order to be subject to the disciplines of the SCM Agreement, this subsidy must also be specific (Article 2).[2241] Alternatively, complainants are allowed to jump directly to the Illustrative List (items (j) or (k)) to demonstrate that export credit support is made at subsidized terms.

4.2.1. Financial contribution by the government

Article 1.1(a)(1) of the SCM Agreement elaborates an exhaustive list of three different types of financial contributions, including 'a government practice [involving] a direct transfer of funds (e.g., grants, loans, and equity infusion), potential direct transfers of funds, or liabilities (e.g., loan guarantees)'.[2242] Obviously, export credit support in its different forms falls under this first type of financial contribution: direct financing support is a direct transfer of funds (e.g., loans or grants) and pure cover support is a *potential* direct transfer of funds as these are only transferred in case the export credit is not repaid because of a covered risk.[2243]

[2238] An *as applied* violation of an individual transaction would strictly speaking require the withdrawal of the subsidy in question, but not of other subsidies not considered. An *as such* violation of a practice would mandate the withdrawal of all subsidies provided under this practice, even if they are not challenged individually, as well as to adapt the WTO-inconsistent practice. Yet, it does not require adapting the legal framework. The latter is also required in case of an *as such* claim against the legal framework. Under the latter claim, if the legal framework is made discretionary but its application (practice or individually) remains unchanged (and thus WTO-inconsistent), the implementation obligations should not be considered fulfilled. In contrast, a new discretionary legal framework without any new practice should be presumed to be applied in a WTO-consistent way ('good faith' rationale), but this presumption should be challengeable (e.g., leaving the executive branch the opportunity to set the conditions for export credits but describing as guideline that their objective should be to undercut market interest rates).

[2239] Article 1.1(a)(1) of the SCM Agreement. Article 1.1(a)(2) is not relevant for our discussion.

[2240] Article 1.1(b) of the SCM Agreement.

[2241] Article 1.2 of the SCM Agreement.

[2242] Article 1.1(a)(1)(iv) of the SCM Agreement is not a type of financial contribution since it deals with the way, namely indirectly, that governments provide one of the different forms of financial contributions. See also WTO Panel Report, *US – Export Restraints*, paras 8.69 and 8.73.

[2243] Except in case of direct credits, the financial contribution by the government is not the export credit, which is extended by the exporter or a private financial institution, but the support to this export credit.

Furthermore, these financial contributions fall within the scope of the SCM Agreement if provided 'by the government or any public body within the territory of a Member'.[2244] The Panel in *Korea – Commercial Vessels* considered a public body as one which is 'controlled by the government', whereby government ownership of 100 per cent is seen as 'highly relevant to and often determinative of government control'.[2245] Additionally, a financial contribution can also be made indirectly by a government through payments to a funding mechanism or when it entrusts or directs a private body to carry out such financial contribution.[2246] The Appellate Body explained that 'entrustment' occurs where a government gives responsibility to a private body, while 'direction' refers to situations where the government exercises its authority over a private body.[2247] In light of this broad formulation, export credit support provided by ECAs, in all their different institutional models, could be subject to the obligations in the SCM Agreement.[2248] First, export credit support by ECAs that are themselves government departments/facilities (as in most OECD countries) are clearly made by the government. Second, other ECAs, mainly in Asia, are modeled as state-owned corporations/agencies which can be considered as public bodies. For example, the Export-Import Bank of Korea (KEXIM) was a 'public body' because it was 100 per cent government-owned and the government appointed leading positions and controlled its operational framework. The fact that Korea itself described KEXIM as 'an export credit agency' also supported the Panel's conclusion.[2249] Third, in some countries export credit support is extended by private financial institutions which act as agents of the government (e.g., Coface in France, Atradius in the Netherlands) and thus seem to be 'entrusted' by the government to offer export credit support.[2250] On the other hand, export credit support extended by private financial institutions without any governmental entrustment or direction falls outside the scope of the SCM Agreement.[2251]

However, an unanswered question is whether export credit support offered by multilateral institutions as a form of development assistance could fall within its scope. Noticing this legal uncertainty, the WTO Secretariat observed that the SCM Agreement is generally drafted to address situations where a WTO Member is subsidizing its own goods and that it is 'not entirely clear whether or not the Agreement applies where the subsidizing entity is not within

[2244] Article 1.1(a)(1), para 1 of the SCM Agreement.
[2245] Panel Report, *Korea – Commercial Vessels*, paras 7.50-7.56 and 7.352–7.356. It also took other factors into account (e.g., importance of the mandate of government-appointed officials).
[2246] Article 1.1(a)(1)(iv) of the SCM Agreement. Panel Report, *US – Export Restraints*, para 8.25.
[2247] Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 116.
[2248] These institutional models are listed in Wang, Mansilla, Kikuchi, and Choudhury, above n 2032, at 6.
[2249] Panel Report, *Korea – Commercial Vessels*, paras 7.50-7.56.
[2250] Governments have an exclusive arrangement with a private financial institution.
[2251] Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 107.

the territory of the Member whose goods are allegedly being subsidized'.[2252] Indeed, in case of trade financing by multilateral institutions, support is in essence given by more developed countries to importers/exporters of emerging developing countries.[2253][2254] The reference in Article 1.1(a)(1) to 'any public body within the territory of a Member' might support a narrow reading and 'many Members appeared to be of the view that development aid provided by multilateral development institutions lay outside the scope of the SCM Agreement, or in any event that it would not be proper to take action under the Agreement in this context'.[2255,2256] This would imply that a certain type of export credit support could be considered prohibited or allowed depending on whether it is the national government or multilateral organization that offers the export credit support.[2257]

Before turning to the benefit element, it should be stressed that ECAs provide export credit *support*. This support only takes the form of an export credit when 'direct credits' are provided. In all other cases of export credit support, 'the financial contribution by the government' is not the export credit in and of itself, because this is extended by the exporter or a private financial institution. Here, the government only supports such export credits by offering, for instance, guarantees or interest rate support.

4.2.2. Benefit element

In the determination of the second constitutive element of a subsidy, the analysis shifts towards the recipient of the financial contribution.[2258] Yet, the case law on export credit practices reveals that the benefit to the *direct* recipient of the financial contribution is not always the appropriate focus. As mentioned above, the financial contribution challenged in

[2252] *General Council, Working Group on Trade, Debt and Finance, Note by the Secretariat, Expert Group Meeting on Trade Financing* (WT/GC/W/527 and WT/WGTDF/W/22, 16 March 2004), para 21. See also Auboin and Meier-Ewert, above n 2030, at 12.

[2253] Horlick also concludes that assistance by multilateral lending institutions falls outside the scope of the SCM Agreement. See G. N. Horlick, 'The WTO and climate change 'incentives'', in in T. Cottier, O. Nartova, and S. Z. Bigdali, *International Trade Regulation and the Mitigation of Climate Change* (Cambridge: Cambridge University Press, 2009), 193-196, at 194. Obviously, export credit support by ECAs also benefits foreign importers in developing countries (see above) but the pivotal difference, in terms of trade-distorting effects as well, is that such export credit support by multilateral institutions for exports to emerging markets is neutral regarding the exporter's country of origin.

[2254] The African Trade Insurance Initiative is somewhat particular as it is set up by a group of African countries to support trade transactions from/to its own member countries. Yet, the initiative is also supported by multilateral donors (e.g., USAID, African Development Bank) and these participating countries also benefit from S&D treatment on export subsidies under the SCM Agreement. See above Part II, Chapter 6, Section 6.1.1.1.

[2255] General Council, above n 2252, para 21.

[2256] Obviously, challenging such support would also require a demonstration that the act of the international institution is attributable to a WTO Member.

[2257] As will be argued in the concluding chapter of this Part (Part III, Chapter 8), this differentiation is also defendable from an economic perspective (see also above n 2253)

[2258] Contextual guidance can be found in Article 14 of the SCM Agreement, which explicitly refers to the 'benefit to the recipient'. Appellate Body Report, *Canada – Aircraft*, paras 154-158. See also Panel Report, *Canada – Aircraft*, para 9.112.

Brazil – Aircraft consisted of interest rate support given by the Brazil under the PROEX programme to financial institutions that provided export credit to foreign buyers of Brazilian regional aircrafts (Embraer). As the Panel in the second compliance proceedings rightly observed, this financial contribution is made to the lender, namely the financial institution. Because such interest rate support takes the form of a grant, it obviously confers a benefit to the financial institution. Yet, Canada had to establish that this benefit 'is passed through in some way to *producers* of regional aircraft'.[2259] Furthermore, the argument that PROEX III bestows a benefit by providing (foreign) regional aircraft *purchasers* with a greater choice of lenders to handle a particular transaction did likewise not in and of itself demonstrate that a benefit was given to (Brazilian) regional aircraft *producers*.[2260] Hence, the relevant question was whether the export credit support was beneficial to the Brazilian *exporter* and not whether it was beneficial to the recipient of this financial contribution (i.e., financial institution)[2261] or to the foreign purchaser receiving an officially supported export credit.[2262] Except for some forms (e.g., insurance to exporter), export credit support is not provided to the exporter directly but, instead, to a financial institution (e.g., guarantee to financial institution) or to the foreign buyer (e.g., direct export credit to foreign buyer).[2263] To be sure, the benefit to the exporter can be induced from the benefit to the purchaser because 'beneficial' export credit support to the latter improves the financial package that an exporter can offer and thus increases its chances of securing the contract.[2264] Therefore, the same Panel in *Brazil – Aircraft* concluded that beneficial export credits to purchasers 'at a minimum, represent a *prima facie* case' that export credit support confers a benefit on the producers.[2265] In deciding on the benefit-element, the case law has therefore examined whether the export credit support improved the financial package that an importer could obtain to finance its purchase. Yet, under what conditions does export credit support confer a benefit?

[2259] Emphasis added. Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, footnote 41.
[2260] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, footnote 41.
[2261] Noteworthy, the Panel observed that the financial contribution to the providers of financial services would not fall within the scope of the SCM Agreement because this is an agreement on trade in goods.
[2262] In *Canada – Aircraft*, Brazil also argued that EDC's financial contributions were beneficial to Canadian exporters (Panel Report, *Canada – Aircraft*, paras 9.183 and 9.247). The Panel in *Brazil – Aircraft* forgot the 'benefit'-element in its analysis, though it was not disputed among the parties. See Panel Report, *Brazil – Aircraft*, paras 7.13-7.14.
[2263] In order to determine the level of countermeasures, the Arbitrators in *Brazil – Aircraft* also calculated the amount of subsidies provided by PROEX to the Brazilian aircraft producers. See Decision by the Arbitrators, *Brazil – Aircraft (Article 22.6 – Brazil)*.
[2264] For example, Panel Report, *(Brazil – Aircraft)*, para 7.34.
[2265] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, footnote 42; Panel Report, *Canada – Aircraft Credits and Guarantees*, footnote 187.

It was in *Canada – Aircraft* that the Appellate Body developed the so-called 'private market test': is the recipient better off than it would otherwise have been, absent the financial contribution?[2266] The cost to the government is not directly relevant since the benefit analysis focalizes on the recipient.[2267] Hence, the fact that the operation of an ECA is self-sustaining, as prescribed by law for some ECAs, should not explicitly be taken into account for the determination of the benefit element.[2268]

However, does the marketplace 'but for' the export credit support refer to a purely commercially market absent of other governments' export credit support? Or instead, should export credit support not be considered beneficial to the foreign buyer if other governments offered the same level of support? The Panel in *Brazil – Aircraft (Article 21.5 – Canada II)* rightly followed the first option as the marketplace referred to must be a '"*commercial* market", i.e. a market undistorted by government intervention' because other governments' export credit support might be made at subsidized rates as well.[2269] Export credit support at below commercial market rates is thus beneficial even though it merely matches offers by other ECAs.

2266 Appellate Body Report, *Canada – Aircraft*, para 157.

2267 See, for example, Panel Report, *Canada – Aircraft*, para 9.115 and Appellate Body Report, *Canada – Aircraft*, para 160. Nonetheless, the same Panel did, indirectly, look at the cost to the government by agreeing with Canada that the comparison of an ECA's net interest margin (NIM) with those of commercial banks is relevant in the benefit analysis. The NIM represents the difference between the gross interest income and *gross interest expense* on all interest-bearing assets (= net interest income), divided by the value of all interest-bearing assets. The cost to the government in raising funds is thus reflected in the NIM. Apparently, the cost to the government might thus still be relevant as evidence that a benefit is conferred upon the recipient, though it is certainly not a necessary condition. Panel Report, *Canada – Aircraft*, paras 9.168-9.174. However, one could question the relevance of an ECAs financial performance relative to commercial banks as this looks at the provider and not at the recipient. On the one hand, an ECA might have a bad financial performance, not because it would offer export credit support at below market rates but due to other factors (e.g., high costs of raising funds, bad management). On the other hand, an ECA with a comparable financial performance to commercial banks (i.e. high NIM) might still systematically offer export credit support at below market rates and thus confer a benefit on its recipients. Recall that the economic rationale for ECAs is based on the information/capacity market failure argument, meaning that the trade finance conditions set by ECAs could be considered commercially sound but the private finance market fails to seize this opportunity. An ECA that exploits its surplus information and capacity could operate commercially sound but at the same time offer export credit support at conditions that the private sector is not able to undertake. ECAs might also block the market entrance of private players for certain export credit instruments. Moreover, some ECAs of developed countries might have a better credit rating (and thus lower borrowing costs) than various commercial banks, because they are covered by the government.

2268 As explained above, by applying the mandatory/discretionary distinction to an *as such* claim, the Panel in *Canada – Aircraft Credits and Guarantees* seemed to recognize that the nature of an ECA does not establish whether a benefit is conferred. The fact that it enjoys advantages vis-à-vis private players (e.g., they do not pay taxes) does not show that this ECA is 'required to pass on those advantages to its clients'. Similarly, ECAs statutory goal to spur exports does not mandate the conferral of a benefit. Panel Report, *Canada – Aircraft Credits and Guarantees*, paras 7.77-7.79.

2269 See Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, para 5.29. See also, summary of the Panel's reasoning by the Panel in *US – Softwood Lumber IV* (para 7.55), in which the Panel adequately distinguished this statement from the question it was confronted with. Panel Report, *Canada – Aircraft Credits and Guarantees,* paras 7.145-7.150. This reasoning seems correct, equally because the focus of the benefit element should be on the exporter.

Several panels and the Appellate Body have already applied the private market test to different forms of export credit support. First, export credit guarantees, a form of pure cover support, are compared with a comparable guarantee available at the commercial market. If the fee charged by the government is lower than the market fee, a benefit would be conferred.[2270] Finding contextual support in Article 14(c) of the SCM Agreement, panels also spelled out a second option for the benefit analysis which looks at the impact of the export credit guarantee on the export credit. It confers a benefit if the difference between the amount paid on a loan guaranteed by the government and the amount that would have to be paid on a commercial loan without government guarantee is not offset by the fee that has to be paid for the government guarantee.[2271] The case law also consistently held that item (j) of the Illustrative List, which delineates a cost-to-government standard, is not relevant for the benefit analysis since the Illustrative List deals with the question whether a prohibited export subsidy exists, and not whether a benefit exists.[2272] Second, concerning types of official financing support, the Panel in *Brazil – Aircraft (Article 21.5 – Canada II)* decided that, if interest rate support is given to the financial institution providing export credits, it should be shown that the supported export credit is extended at more favourable terms than those available on the commercial market to the purchaser.[2273] Furthermore, when official financing support takes the form of direct credits to the purchaser, the terms of this export credit are compared with commercial export credits. A benefit would be conferred if, absent the export credit by the government, the purchaser would not be able to obtain a loan at the same terms on the commercial market.[2274] For the same reasons as with regard to item (j), paragraph 1 of item (k) of the Illustrative List can also not be relied upon as contextual support for demonstrating the presence of a benefit.[2275]

Yet, might the OECD Arrangement be used for demonstrating/refuting that an export credit is supported at below market terms? The Panel in *Canada – Aircraft Credits and Guarantees* held that the fact that the repayment term exceeds the maximum term authorised under the OECD Arrangement does not constitute positive evidence that a benefit is conferred.[2276] On

[2270] Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.189.

[2271] The Panel in *Canada – Aircraft Credits and Guarantees* deemed it 'safe to assume' that this would be the case if the fees are not market-based. Hence, it considered the standard similar under both options. Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.190; Panel Report, *Canada – Aircraft Credits and Guarantees,* paras 7.397-7.398.

[2272] Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.191.

[2273] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, paras 5.27-5.28: 'There would be no need for complex benefit analysis if PROEX III payments were made directly to producers or to purchasers of Brazilian regional aircraft'.

[2274] This is in line with the standard for calculating the benefit of a loan elaborated in Article 14(b) of the SCM Agreement, which again provides relevant context. Panel Report, *Canada – Aircraft*, para 9.113. Appellate Body Report, *Canada – Aircraft*, paras 155-156.

[2275] Panel Report, *Canada – Aircraft*, para 9.117.

[2276] Panel Report, *Canada – Aircraft Credits and Guarantees,* paras 7.232-7.236.

the other hand, the same Panel was more willing to take the CIRR into account because this could serve as a *rough* proxy for commercial interest rates.[2277] An interest rate below the CIRR establishes a *prima facie* case that a benefit is bestowed.[2278] This finding could thus be rebutted because the CIRR is a constructed interest rate at a particular moment in time and might lag behind the market rate. Hence, financing below CIRR level is not necessarily extended at better-than-market terms. Conversely, as the Panel in *Brazil – Aircraft (Article 21.5 – Canada II)* held, an interest rate at or above the CIRR does not establish that it does *not* confer a benefit, as CIRR corresponds to commercial interest rates for first-class borrowers.[2279] Consequently, the prescription that an export credit programme should be based on the CIRR does not demonstrate the absence of a benefit. To the contrary, an *as such* claim against an export credit programme *prescribing* the application of the CIRR would be accepted with respect to the benefit element because such programme requires to confer a benefit in some situations (namely to less creditworthy borrowers).[2280]

In conclusion, export credit support is deemed beneficial if it confers upon the foreign buyer an export credit at terms unavailable on the commercial market. Interestingly, export credit support that is commonly deemed legitimate might very well confer a benefit in the meaning developed in the case law. First, export credit support is considered necessary to match support given by other ECAs (self-defence instrument), but such support is beneficial because it is not available on the *commercial* market at similar terms.[2281] Second, export credit support is generally legitimized on the basis of an information/capacity market failure in the private market. Here again, export credit support provided by ECAs is beneficial if it aims at correcting such market failures because private investors are, due to their limited information/capacity, unwilling or unable to provide export credits at the same terms. Even if such an ECA is operating on commercial principles, its support would be beneficial as such support would not be offered on the commercial market. Third, in times of financial crises, ECAs are incited to support those transactions that the private sector is no longer willing or able to finance at affordable rates. When filling this gap in private trade financing, governments are thus subsidizing in the meaning of the SCM Agreement. Put otherwise,

[2277] The OECD Arrangement indicates that CIRRs should 'represent final commercial lending interest rates' and 'closely correspond to the rate for first-class domestic borrowers' (Panel Report, *Canada – Aircraft Credits and Guarantees,* para 7.241). The Panel cited Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, para 5.35.

[2278] Panel Report, *Canada – Aircraft Credits and Guarantees,* para 7.241.

[2279] Because CIRR corresponds to commercial interest rates for 'first-class' borrowers, it is thus 'certainly not a precise market proxy for rates which borrowers of lesser creditworthiness could obtain in the market' (at least, if an export credit programme is not limited to first-class borrowers). Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, para 5.36.

[2280] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, paras 5.36-5.37.

[2281] If the commercial market provided export credits at similar terms, there would be no need for matching.

ECAs only serve their legitimate purpose of *complementing* the private market if they provide subsidies as defined in the SCM Agreement.[2282] Of course, it should always be explicitly demonstrated that ECAs *as such* or *as applied* offer support at better-than-market terms.

In the next section, we look at the question whether such subsidized export credit support could qualify as an export subsidy under the SCM Agreement, whereby it should be recalled that export subsidies are deemed to be specific.[2283]

4.3. IS SUBSIDIZED EXPORT CREDIT SUPPORT A PROHIBITED EXPORT SUBSIDY UNDER THE SCM AGREEMENT?

4.3.1. Article 3.1(a) of the SCM Agreement

Complaining Members have two options to demonstrate that a subsidy is an export subsidy within the meaning of the SCM Agreement. First, it can be demonstrated on the basis of Article 1 *juncto* 3 of the SCM Agreement. Concerning the export contingency element, observe that export credit support is, by its very nature, contingent upon exportation as it supports loans (or is a loan in itself) extended to foreign buyers and will thus generally be 'de jure' contingent upon exportation.[2284] If there is no disagreement that a financial contribution conferring a benefit could be considered as export credit support, the – often thorny – demonstration of 'export contingency' is therefore easily fulfilled and not disputed.[2285] Instead of demonstrating the subsidy element as explained in the previous section, the complaining Member can directly rely on items (j) or (k) of the Illustrative List to show that export credit support constitutes an export subsidy.

Hence, if export credit support is deemed an export subsidy, on the basis of either Article 1 *juncto* Article 3.1(a) or the Illustrative List, it is prohibited pursuant to Article 3 unless an exception applies. Next to illustrations of export subsidies, the Illustrative List also contains exceptions to the principle prohibition on export subsidies. With respect to export credit support, such an exception can be found in paragraph 2 of item (k), which refers to the OECD

[2282] The subsidy definition does not take the objective of the government intervention into account. By definition, the private market test detects government interventions that aim at correcting market failures.

[2283] As explained, export subsidies that are not prohibited because of an exception (e.g., OECD Arrangement) are also deemed specific. Implicitly, this seems to be confirmed by the Panel in *Korea – Commercial Vessels* (para. 7.514): 'we consider that Article 2.3 applies in respect of the entirety of the *SCM Agreement*. Thus, a subsidy that is specific under Article 2.3 (*as a result of export contingency*) is specific for the purpose of both Part II (prohibited export subsidy) and Part III (actionable subsidy) claims' (emphasis added).

[2284] See, for example, Panel Report, *US – Upland Cotton*, footnote 951. *De jure* export conditionality should be 'demonstrated on the basis of the words of the relevant legislation, regulation or other legal instrument'. Appellate Body Report, *Canada – Aircraft*, para 167.

[2285] Obviously, the only relevant question under Article 3.1(a) is whether a beneficial financial contribution is contingent upon exportation and not whether it constitutes export credit support.

Arrangement. Additionally, some developing countries still benefit from S&D treatment on export subsidies.

4.3.2. Export credit support as an export subsidy pursuant to items (j) and (k) of the Illustrative List of Export Subsidies

4.3.2.1. Item (j) of the Illustrative List

Item (j) of the Illustrative List reads in the relevant parts:

> The provision by governments (or special institutions controlled by governments) of export credit guarantee or insurance programmes, (…), at premium rates which are inadequate to cover the long-term operating costs and losses of the programmes.[2286]

The Panel in *Korea – Commercial Vessels* defined an export credit guarantee in a narrow sense as a guarantee which covers default by a foreign buyer in respect of an export credit provided to that foreign buyer.[2287] Item (j) considers export credit guarantee (or insurance) programmes as prohibited export subsidies if they are offered at premium rates inadequate to cover the long-term operating costs and losses of the programme.[2288] Hence, item (j) applies a cost-to-government standard rather than the benefit-to-recipient standard developed under Article 1.1(b) of the SCM Agreement.[2289] Moreover, the evaluation is made at an aggregate level and looks at the overall cost to the government.[2290] If a cost-to-government standard is applied to guarantees/insurance, a determination can indeed not be made on a transaction basis because the individual cost-to-government varies depending on whether or not the risk occurs. The application of this standard might have important implications because it means, according to the Panel in *Korea – Commercial Vessels*, that 'if a complaining party establishes that another Member's export guarantee programme fails overall to cover its long-term operating costs and losses, that is sufficient for a finding that the *programme as a whole* constitutes a prohibited export subsidy'.[2291]

The question on how this cost-to-government test should be passed is explored in more detail in the discussion on export credit support for agricultural products since this test was central in the *US – Upland Cotton* case. Obviously, the jurisprudence developed in this case is also relevant for challenging pure cover support for non-agricultural products under item (j).

[2286] Emphasis added.
[2287] A guarantee for a loan made in the context of an export transaction is insufficient to label it as an export credit guarantee. Panel Report, *Korea – Commercial Vessels*, para 7.213.
[2288] Recall that the qualification 'manifestly' was deleted in the Uruguay Round.
[2289] Panel Report, *EC – Countervailing Measures on DRAM Chips*, para 7.191.
[2290] Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para 93.
[2291] Panel Report, *Korea – Commercial Vessels*, para 7.204 (emphasis added). See also Panel Report, *US – Upland Cotton*, para 8.1(d)(i).

4.3.2.2. Item (k), paragraph 1 of the Illustrative List

Item (k), para 1 of the Illustrative List reads in the relevant parts:

> The grant by governments (...) of export credits at rates below those which they actually have to pay for the funds so employed (…), or the payment by them of all or part of the costs incurred by exporters or financial institutions in obtaining credits, in so far as they are used to secure a material advantage in the field of export credit terms.

First of all, this item deals with export credits provided by ECAs (direct credits). Such a loan by an ECA to a foreign buyer contains a cost to the government if it is made at interest rates below the rate the government itself had or would have to pay for the funds.[2292] Here again, a cost-to-government standard is inscribed but, contrary to item (j), this standard can be applied on an individual transaction basis.[2293] Next, item (k) also targets 'the payment (by the government) of all or parts of the costs incurred by exporters or financial institutions in obtaining credits'. Even though the panel in *Brazil – Aircraft (Article 21.5 – Canada)* decided otherwise, the term 'payments' seems to include interest rate support and might as well cover refinancing if an expansive interpretation would be accepted.[2294] This standard does not refer to the cost to the government but to the cost to the exporter or financial institution.[2295]

[2292] Loans to exporters, rather than to foreign buyers, are not considered 'export credits' under this provision. See Panel Report, *Korea – Commercial Vessels*, para 7.328.

[2293] Indeed, the interest rate for an individual export credit extended by an ECA can be meaningfully compared with the cost to the government of raising the required funds thereto.

[2294] The Panel in *Brazil – Aircraft (Article 21.5 – Canada)* concluded that payments that amount to interest rate support to lenders (exporters and financial institutions) fall outside this scope because *credits* refer to *export credits* and the costs involved are those relating to *obtaining* export credits, and not costs relating to providing them. This reading of credits as *export credits* is simply impossible in light of a correct understanding of the latter term as defined by the Panel in *Korea – Commercial Vessels* (see above n 2292 and n 2033). As the plain text reads, the costs are those incurred by exporters or financial institutions in *obtaining* credits and, by definition, exporters or financial institutions cannot obtain exports credits because these are obtained by foreign buyers. Moreover, the negotiating history suggests that the word 'credits' does not refer to 'export credits'. The 1960 Declaration separately listed 'the government bearing all or part of the costs incurred by exporters in obtaining credit", which was integrated in a slightly modified form in item (k) in the Subsidies Code. An early draft of this Code referred to 'in obtaining *credit*' but this was, for unclear reasons (maybe to align with the French and Spanish version or by mistake), revised to 'in obtaining *credits*'. Compare the following drafts: *Subsidies/Countervailing Measures – Outline of an Arrangement* (MTN/NTM/W/210, 19 December 1978) and *Subsidies/Countervailing Measures – Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade* (MTN/NTM/W/220, 21 February 1978). Surprisingly in contradiction to its own interpretation, the same Panel seemed to endorse this view when it elaborated as an example of a payment under para 1 item (k) '(a) payment by Brazil that allowed a Brazilian financial institution to provide export credits to an overseas customer'. Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, paras 6.44, 6.71- 6.72.

[2295] As Canada correctly argued in *Brazil – Aircraft (Article 21.5 – Canada),* para 6.70: 'a payment exists within the meaning of the first paragraph of item (k) where an exporter or financial institution obtains credits at an interest rate higher than the rate at which it would provide export credits to a buyer and incurs a cost as a result, and the government pays for all or part of this difference'. In case of interest rate support, this would *ipso facto* incur a cost to the government but this is not necessarily so in case of refinancing since the government might have a lower cost of borrowing than the exporter or financial institution. The material advantage clause (see below) precludes that all types of credit to exporters or financial institutions which are supported by government payments are prohibited export subsidies under

The Subsidies Code added to paragraph 1 of item (k) the phrase 'in so far as they are used to secure a material advantage in the field of export credit terms'. However, the text does not reveal if this material advantage clause only applies to credits supported by government payments (e.g., interest rate support; second aspect item (k)) or to export credits provided by the government as well (direct credits; first aspect item (k)).[2296] The Panel in *Korea – Commercial Vessels* decided, without any explanation, that the material clause also applies to direct credits and the Appellate Body seemed to share this interpretation.[2297] Until today, panels and the Appellate Body have not been able to advance a convincing interpretation of this material advantage condition.[2298] In examining whether interest rate support was used to secure a material advantage, the Appellate Body in *Brazil – Aircraft* rejected the Panel's approach to conduct a private market test because this equated this test with the benefit analysis.[2299] The Appellate Body held that 'whether or not a government payment is used to secure a "*material* advantage", as opposed to an "advantage" that is not "material", may well depend on where the *net* interest rate applicable to the particular transaction at issue in that case stands in relation to the range of commercial rates available'.[2300] The net interest rate is defined as the actual interest rate after deduction of the government payment. When this interest rate is below the *relevant CIRR*, this is a positive indication that the government payment has been 'used to secure a material advantage'.[2301] If so, the defending party could still argue that an alternative 'market benchmark' other than the CIRR is appropriate, and that

item (k), because only those used to secure a material advantage *in the field of export credit terms* are covered.

[2296] Depending on the interpretation of the pronoun 'they', two readings could be advanced: (i) it could refer to *export credits* and *payment* and thus condition both aspects of item (k), para 1; or (ii) it could refer to *credits* under the second aspect and, as a result, be confined to this aspect.

[2297] In elaborating a hypothetical example, the Panel in *Brazil – Aircraft (Article 21.5 – Canada)* assumed that the material clause also applies to direct credits, but equally indicated the consequence if this would not be the case. Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, footnote 45; Panel Report, *Korea – Commercial Vessels*, para 7.314. According to the Appellate Body, 'the payment' is considered an export subsidy if it fails the material advantage condition. Because semantically 'they' cannot refer exclusively to 'payment' (above n 2296), the Appellate Body's reading implies that the material advantage clause also applies to direct credits. See Appellate Body Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para 61. Brazil highlighted that one negotiator noted that this clause was intended to provide 'a weak injury test in the event of a departure from the basic GATT (subsidy) standard'. Appellate Body Report, *Brazil – Aircraft*, para 20. This was also confirmed by Hufbauer and Erb (above n 2128, at 70) and might suggest that the material advantage indeed covers both aspects of item (k), para 1. This reading might also find support in the negotiating history, given that one of the drafts of the Subsidies Code referred to 'in obtaining *credit*' in the singular (see above n 2294) and already included the qualification 'insofar as *they* are used (…)'. See *Multilateral Trade Negotiations, Group "Non-Tariff Measures", Sub-Group "Subsidies and Countervailing Duties", Subsidies/Countervailing Measures – Outline of an Arrangement* (MTN/NTM/W/210, 19 December 1978).

[2298] Hufbauer and Erb held that that this included a weak injury test. Hufbauer and Erb, above n 2128, at 70.

[2299] Appellate Body Report, *Brazil – Aircraft*, paras 176-179.

[2300] Appellate Body Report, *Brazil – Aircraft*, para 182.

[2301] Appellate Body Report, *Brazil – Aircraft*, para 182. In case of direct credits, the actual interest rate is similar to the net interest rate.

the net interest rate is at or above this alternative market benchmark.[2302] Applying this interpretation in the first compliance procedure, the Appellate Body distinguished two options to demonstrate that the subsidies under the revised PROEX were not 'used to secure a material advantage':

> (…) Brazil must prove *either*: that the net interest rates under the revised PROEX are at or above the relevant CIRR, (…); *or*, that an alternative "market benchmark", other than the CIRR, is appropriate, and that the net interest rates under the revised PROEX are at or above this alternative "market benchmark".[2303]

Yet, it was left undecided whether conformity with the relevant CIRR is sufficient on itself, as this Appellate Body's statement seems to suggest, or whether related disciplines of the OECD Arrangement (e.g., repayment terms) should in addition be respected to conform with the material advantage clause. Considering it would be 'implausible to assume that the Appellate Body meant to "import" into the "material advantage" clause the CIRR alone', the Panel in the second compliance procedure rightly decided that those rules of the OECD Arrangement operating to support or reinforce the CIRR should equally be respected. Deciding otherwise would deprive the material advantage clause from any meaningful effect. After all, this would mean that any export credit support with interest rates at CIRR level would be in conformity with paragraph 1 of item (k), *irrespectively* of all the other terms and conditions (e.g., repayment term of 100 years).[2304] The Panel was well aware that its interpretation equated the standard under the material advantage clause with the conditions set under safe haven (paragraph 2 of item (k)) and thus that it made the safe haven redundant for justifying violations of the first paragraph of item (k). However, the Panel subtly – but correctly – observed that this was 'an unavoidable implication of the Appellate Body's adoption of the CIRR as an appropriate benchmark for determining the existence of a material advantage'.[2305]

[2302] Appellate Body Report, *Brazil – Aircraft (Article 21.5 – Canada)*, paras 67 and 74.

[2303] Appellate Body Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para 67.

[2304] In the words of the Panel, it would mean that 'Members could, for instance, support export credits with net interest rates at CIRR level, repayment terms of 100 years, no cash payment requirement and with the principal sum to be repaid at the very end of the credit term' without violating paragraph 1 of item (k). Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, paras 5.242-5.243. What is more, if the Appellate Body would accept an *a contrario* interpretation of the first paragraph of item (k), an interpretation of the 'material advantage' clause solely on the basis of the CIRR would also introduce much more flexibility for official financing support as the OECD Arrangement exception mandates not only conformity with CIRR but with all the relevant interest rate provisions of the OECD Arrangement (see below). The Panel also seemed to allude to this argument. Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, para 5.271.

[2305] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, para 5.251.

4.3.3. The relationship between Article 3.1(a) of the SCM Agreement and the Illustrative List of Export Subsidies

The text of Article 3.1(a) of the SCM Agreement leaves no doubt that the Illustrative List only offers examples of export subsidies. Clearly, export subsidies falling *outside* the Illustrative List's scope are prohibited by virtue of Article 1 *juncto* 3 of the SCM Agreement. Equally undisputed is the fact that a subsidy falling *within* the scope of the Illustrative List is deemed to be a prohibited export subsidy unless an exception applies. Yet, two elements on the relationship between Article 3.1(a) and the Illustrative List (item (j) and (k)) merit some further reflection.

First, when could the Illustrative List be relied upon to demonstrate that export credit support is *not* prohibited? Second, the case law reads the items of the Illustrative List as *per se* export subsidies under the SCM Agreement. Hence, these items could be used to circumvent the 'export contingency' test of Article 3.1(a) SCM Agreement as well as the 'subsidy' test under Article 1 of the SCM Agreement.[2306] Is it relevant for the disciplines on export credit support that items (j) and (k) of the Illustrative List are considered such *per se* export subsidies?

4.3.3.1. Could item (j) and paragraph 1 of item (k) be used a contrario?

As introduced in Part II, panels have systematically rejected that all items of the Illustrative List could be used *a contrario* so as to justify that an export subsidy in the meaning of Article 1 *juncto* 3 of the SCM Agreement (or the Illustrative List) is *not* prohibited under the SCM Agreement. By virtue of footnote 5 of the SCM Agreement, panels have only accepted such an *a contrario* reasoning for those items containing an *affirmative* statement that a measure is not subject to the Article 3.1(a) prohibition, that it is not prohibited, or that it is allowed. Concerning the relevant items on export credit support, panels detected such an affirmative statement in paragraph 2 of item (k), which refers to the OECD Arrangement. Hence, they accepted that conformity with this safe haven implies that the export credit practice is *not* prohibited under the SCM Agreement. The scope of this exception is explored in the next section. On the other hand, item (j) and paragraph 1 of item (k) do not contain such an affirmative statement and can therefore not be used *a contrario*. Next to pointing to textual support in footnote 5, the Panel in *Brazil – Aircraft (Article 21.5 – Canada)* advanced the following two arguments to underpin this conclusion.

First, the Panel disagreed with Brazil that this interpretation would render items (j) and (k) ineffective. These are still useful because it is possible to demonstrate that a measure falls within the scope of items (j) or (k) without 'being required to demonstrate that Article 3, and

[2306] See above Part II, Chapter 4, Section 4.1.1.

thus Article 1, was satisfied' (*per se* export subsidies).[2307] Second, the Panel also rejected that its narrow reading would disadvantage developing countries. In contrast, it convincingly explained that a broad interpretation would allow developed countries to consistently offer export credit at terms more favourable than developing countries which is 'at odds with one of the objects and purposes of the *WTO Agreement* generally and the *SCM Agreement* specifically'.[2308] After all, the cost-to-government standard elaborated under these items systematically favour developed countries.[2309] Given that the cost of borrowing is higher for developing countries, paragraph 1 of item (k) 'would "permit" developed countries to provide export credits at an interest rate – the developed countries' own cost of funds – which developing countries would almost never be able to meet without falling afoul of the *SCM Agreement*'.[2310] Next, in case of an export credit guarantee or insurance (item (j)), the financial terms of the export credit are based on the risk of the guarantor government and not of the borrower. Because developing countries have a higher perceived risk than developed countries, a guarantee at similar cost-recovering premium rates would have less impact on the export credit's financial terms if extended by developing countries. Consequently, item (j) offers leeway to developed countries to support export credits at interest rates that would be consistently lower than those supported by developing countries. Yet, under the narrow reading adopted by the Panel, 'WTO Members are faced with a common set of rules in respect of export credit practices'.[2311] Indeed, export credit support involving no cost to the government would still be prohibited by virtue of Article 1 *juncto* 3 of the SCM Agreement if conferring a benefit to the recipient. This benefit-to-recipient standard disregards differences in the cost to the government. Hence, the Panel's rejection of an *a contrario* reasoning under items (j) and paragraph 1 of (k) seems solid from a systemic point of view because it reduces the legal implications of the cost-to-government standard. This standard is hard to reconcile with the benefit-to-recipient standard articulated under Article 1.1(b) of the SCM Agreement. Although it several times had the opportunity, the Appellate Body until present has not articulated whether it would agree that an *a contrario* reading of these items should be dismissed.[2312] It merely held that if the conditions of the first paragraph of item (k) would have been fulfilled, it 'would have been prepared to find that the payments (…) are *justified* under item (k) of the Illustrative List' but, at the same time, wished 'to emphasize that (it was)

[2307] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para 6.42.
[2308] Recognizing S&D provisions (Article 27 of the SCM Agreement), the Panel held that this structural disadvantage would at least be the case as 'of the date the export subsidy prohibition applies to any given developing country Member'. Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para 6.47.
[2309] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, paras 6.58-6.59.
[2310] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para 6.58.
[2311] Except for S&D treatment for developing countries (see below Part III, Chapter 4, Section 4.5). Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, paras 6.60 and 6.61.
[2312] See, for example, Appellate Body Report, *US – Upland Cotton*, paras 730-731.

not interpreting footnote 5 of the SCM Agreement'.[2313] Confronted with this ambiguous statement, the panels in *Brazil – Aircraft (Article 21.5 – Canada II)* and *Korea – Commercial Vessels* aligned with the Panel in *Brazil – Aircraft (Article 21.5 – Canada)* and thus rejected an *a contrario* reading of item (j) and paragraph 1 of item (k).[2314]

4.3.3.2. The relevance of item (j) and paragraph 1 of item (k) as per se export subsidies

The case law reads the items of the Illustrative List as *per se* export subsidies. This means that a complainant challenging export credit support could jump directly to items (j) or (k) without the obligation to demonstrate that such support is conferring a benefit upon the exporter. Should complainants be advised to base their claim in first order on the Illustrative List or on Article 1 *juncto* 3 of the SCM Agreement?

First, item (k) does not seem to enlarge the subsidy definition of Article 1 since official financing support that is 'used to secure a material advantage' as understood by the Appellate Body would be *ipso facto* beneficial under Article 1.1(b) of the SCM Agreement. As item (k) also refers to individual official financing support transactions but requires an additional cost-to-government (or exporter/financial institution) demonstration, complainants might more easily opt for Article 1 *juncto* Article 3 to demonstrate the existence of an export subsidy.[2315]

Second, the standard in item (j) refers to the pure cover *programme* and if this programme runs at a loss, '*the programme as a whole* constitutes a prohibited export subsidy'.[2316] However, challenging such a pure cover programme under Articles 1 and 3 of the SCM Agreement seems more difficult in light of the mandatory/discretionary distinction adopted by most panels. Recall its application by the Panel in *Canada – Aircraft Credits and Guarantees*: programmes can only be challenged *as such* and should thus *mandate* WTO-inconsistent implementation (i.e., leaving no discretion to apply it in a WTO-consistent manner) in order to violate WTO disciplines, in contrast to *as applied* claims that can only be made on the level of individual transactions.[2317] If this distinction is rigorously applied, challenging a pure cover programme can only pass the subsidy threshold of Article 1 if the programme '*as such*'

[2313] Appellate Body Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para 80 (emphasis added). Observe that the Appellate Body stated that it would be justified *under item (k)* and not that it would be justified as such.

[2314] The Panel in *Brazil – Aircraft (Article 21.5 – Canada II)* acknowledged that 'this statement could be understood (to allow an *a contrario* reading)', but noted 'the Appellate Body's statement does not form part of the legal basis for its disposition of the appeal, nor did the Appellate Body explain its statement'. The Panel in *Korea – Commercial Vessels*, on the other hand, emphasized the second part of the Appellate Body's statement. Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, footnote 214; Panel Report, *Korea – Commercial Vessels*, paras 7.195-7.207.

[2315] This is what Brazil and Canada did in *Canada – Aircraft* (and *Canada – Aircraft Credits and Guarantees*) and *Brazil – Aircraft*, respectively.

[2316] Panel Report, *Korea – Commercial Vessels*, para 7.204 (emphasis added). See also Panel Report, *US – Upland Cotton*, para 8.1 (d)(i).

[2317] Panel Report, *Canada – Aircraft Credits and Guarantees,* para 7.131. Only one relaxation seemed to be accepted (see footnote 93).

mandates the conferral of a benefit, which is often not the case. Alternatively, individual pure cover transactions (*as applied*) could be demonstrated to confer a benefit and thus in principle be prohibited, but implementation would not extend beyond these individual transactions. Somewhat qualifying this distinction, the Appellate Body also seems to allow the *as such* challenging of a programme's systematic application. Anyway, a claim under Article 1 of the SCM Agreement will always be confronted with the thorny (and conflicting) case law on *as such* and *as applied* claims. On the other hand, as the Panel in *US – Upland Cotton* illustrated, the application of this controversial mandatory/discretionary distinction could be tactfully avoided under item (j):

> Brazil challenges these (export credit guarantee programmes) both "as such" and "as applied". Because of the analytical approach (…) based on the contextual guidance available under item (j) of the Illustrative List of Export Subsidies in Annex I to the *SCM Agreement*, we do not view this distinction as a determinative one here. Item (j) refers to the provision by governments of export credit guarantee "programmes".[2318]

Hence, challenging a pure cover programme is easier on the basis of item (j) than on the basis of Article 1 *juncto* Article 3 of the SCM Agreement. If the threshold of item (j) is fulfilled, the programme as a whole would be considered a prohibited subsidy, regardless of whether the programme *as such* or *as applied* also confers a benefit. But what should be understood under the obligation to 'withdraw *the subsidy* without delay'[2319] if the subsidy element is demonstrated on the basis of the cost-to-government standard under item (j) and not on the basis of the benefit-to-recipient standard?[2320] Could the defendant implement such finding by ensuring that its pure cover programme no longer runs at a cost to the government, even though it might still be beneficial *as such* or *as applied* under Article 1 of the SCM Agreement? Precisely to prevent such an outcome, Brazil also formulated a separate claim under Article 1 *juncto* 3 of the SCM Agreement in *US – Upland Cotton*. As will be discussed below in more detail, however, judicial economy was exercised on this additional claim. Nonetheless, the Arbitrator in the same case decided that full compliance would only be present if no benefit upon recipients is conferred. Hence, when challenging pure cover support, WTO Members might be advised to base their claim in first order on item (j), given that implementation would anyway encompass the benefit-to-recipient standard. On the other hand, in the absence of explicit panel findings under Article 1 *juncto* 3 of the SCM Agreement, there might be little guidance – and thus substantive leeway in practice – for the implementing country on to how it should achieve such full compliance.

[2318] Panel Report, *US – Upland Cotton*, para 7.763.
[2319] Article 4.7 of the SCM Agreement (emphasis added).
[2320] As elaborated above, panels have acknowledged that pure cover support programmes operating at no cost to the government could still be beneficial (see above n 2309).

4.3.4. Export credit practices which are not prohibited: The OECD Arrangement safe haven

By its terms, export credit practices that fulfill the conditions of paragraph 2 of item (k) are not prohibited by the SCM Agreement.[2321] So, this safe haven is an important exception to the principle prohibition of export subsidies stipulated in Article 3 of the SCM Agreement.

The safe haven, included in the Subsidies Code, refers in indirect terms to the original OECD Arrangement. Because the exception is extended to any 'successor undertaking', the Panel in *Brazil – Aircraft (Article 21.5 – Canada II)* held that the relevant version of the OECD Arrangement (including sector understandings) under the safe haven is the most recent one that has been adopted.[2322] To be sure, the reference to a 'successor undertaking' does not give non-Participants to the OECD Arrangement the option to draft their own alternative undertaking as item (k) explicitly prescribes that such a successor undertaking should be adopted by the original Participants of the OECD Arrangement.[2323] On the other hand, the safe haven is, by its own terms, not only available to Participants of the OECD Arrangement (currently 9 Participants, including the EC with 27 Member States) but to all WTO Members applying the interest rate provisions of the Arrangement in practice.[2324] For example, Brazil as non-Participant successfully claimed before the panel in *Brazil – Aircraft (Article 21.5 – Canada II)* that its revised PROEX was in accordance with the safe haven.[2325]

The Panel in *Brazil – Aircraft (Article 21.5 – Canada II)* underscored the 'unusual' character of the safe haven and acknowledged the risk that, if the latest version is considered relevant, Participants to the OECD Arrangement '*could* conceivably abuse their *de facto* power to modify the scope of the safe haven in a way which benefits them but does not equally benefit the rest of the WTO membership'.[2326] At the same time, the Panel acknowledged that the appropriate weight given to this consideration 'is the task of the parties to a negotiation, not a dispute settlement panel'.[2327] Nonetheless, by analyzing the safe haven from the angle of the SCM Agreement, panels have to some extent tied the hands of Participants in defining its scope and application.

[2321] Item (k), para 2 *juncto* footnote 5. Appellate Body Report, *Brazil – Aircraft*, para 180; Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para 6.36.

[2322] Only if the new version is formally accepted by the Participants, could it be applied as benchmark. Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, paras 5.72-5.91.

[2323] The wording 'successor' also indicates that it should be linked to the OECD Arrangement.

[2324] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, paras 6.52 and 6.61. The IMF seemed not to recognize that the safe haven is available to developing countries. *Communication from the IMF, Export Financing and Duty Drawbacks* (WT/TF/COH/15, 14 February 2003), para 12.

[2325] Before the original Panel, Brazil had not invoked this exception as it considered compliance with the OECD Arrangement as too expensive. See Appellate Body Report, *Brazil – Aircraft*, para 180. Brazil recently became Participant to the Sectoral Understanding for Civil Aircraft, which is annexed to the OECD Arrangement.

[2326] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, para 5.87 (emphasis in the original).

[2327] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, paras 5.88- 5.89. See also Panel Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para 5.132.

4.3.4.1. Potential and actual scope of the safe haven

The safe haven applies to an 'export credit practice' and this 'must be a relatively broad term' in its ordinary meaning.[2328] No practice associated with export credits could *a priori* be excluded from its scope.[2329] As a result, the safe haven is in principle not restricted to direct credits (first part of item (k), para 1) but extends to other types of official financing support such as interest rate support (second part of item (k), para 1) and pure cover (item (j)). Hence, it could *potentially* be invoked to justify an export credit guarantee programme incurring a cost to the government.[2330]

Yet, the actual scope of the safe haven is more narrow than this potential scope since it is stipulated that export credit practices in conformity with 'the interest rate provisions' of the OECD Arrangement are not prohibited. A precondition for an export credit practice to be in *conformity with* the interest rate provisions, is that it is *subject to* those provisions.[2331] For various reasons elaborated in the next section, panels have adopted a narrow interpretation of the term 'interest rate provisions' by only including those provisions related to the CIRR.[2332] Accordingly, the potentially wide scope is narrowed to those export credit practices subject to minimum interest rate requirements under the most recent version of the OECD Arrangement. As a result, the actual scope of the safe haven is confined to those export credit practices which (a) are in the form of official financing support (i.e. direct credits/financing, refinancing, or interest rate support), (b) have repayment terms of at least two years, and (c) have fixed interest rates.[2333] Export credit support not satisfying these three elements actually falls outside the scope of the safe haven. Here, three main examples could be discerned. First, official export credit support with repayment terms below two years falls outside the scope of the OECD Arrangement and could *a fortiori* not be subject to its interest rate provisions. Given that ECAs are more and more replaced by private actors as providers of short-term credits, this might in general not raise a serious concern. Yet, such private flows of short-term credit often run dry in case of a financial crisis, especially to developing countries. Hence, the SCM Agreement currently prohibits ECAs to fill this gap by offering

[2328] Panel Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para 5.80.
[2329] Panel Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para 5.81.
[2330] Even though this might not have been intended when the safe haven was inscribed in the Subsidies Code (see above n 2140), extending its application to item (j) violations conforms to the view under the SCM Agreement that the Illustrative List does not deal with certain specific types of subsidies in an exclusive way. The safe haven could potentially even be invoked to justify export credit practices that fall outside the prohibitions in items (j) and (k) but are prohibited on the basis of Article 3.1(a) of the SCM Agreement. An example thereof is an export credit guarantee conferring a benefit to the exporter which is extended under a programme not involving a cost to the government. See also Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, para 6.61.
[2331] Panel Report, *Canada–Aircraft (Article 21.5 – Brazil)*, para 5.93.
[2332] The provision on CIRR is pivotal because it is 'the only minimum interest rate system defined and thus regulated' by the OECD Arrangement. In contrast, provisions on minimum premiums are not 'interest rate provisions'. Panel Report, *Canada–Aircraft (Article 21.5 – Brazil)*, paras 5.83-5.92.
[2333] Panel Report, *Canada–Aircraft (Article 21.5 – Brazil)*, para 5.106.

support for short term export credits.[2334] Second, it did also come as a surprise to several Participants that official financing support at floating rates was not covered by the safe haven.[2335] Such support could in the future be eligible if minimum interest rates would be negotiated.[2336] Third, pure cover support falls outside the actual scope of the safe haven because it is not subject to the minimum interest rate provisions (the CIRR) but only to disciplines on minimum premiums (and repayment requirements). The Panel correctly concluded that pure cover support would be in accordance with the OECD Arrangement in case it respects the disciplines on minimum premium rates (MPRs) (and repayment requirements) even if, as a result, the covered export credit would fall below the CIRR. Indeed, the approach taken under the Knaepen Package disciplines the premium rates for pure cover support directly, regardless of their effect on the interest rate of the export credit. According to the Panel, however, this is insufficient to bring pure cover support under the safe haven. In conclusion, neither item (j) nor item (k), para 2, safeguards beneficial pure cover support that is in conformity with the OECD Arrangement from being prohibited under the SCM Agreement. The safe haven could in the future extend to pure cover support but only if the covered export credits are made subject to minimum interest rates.[2337]

In conclusion, the scope of the safe haven in theory lies in the hands of the OECD Arrangement Participants, certainly given the broad interpretation of an 'export credit practice' by the panels. Yet, panels added one important caveat. Such an export credit practice should not only be brought within the scope of the OECD Arrangement but also be made subject to its minimum interest rate requirements.

4.3.4.2. Conformity with the safe haven

Only official financing support with repayment terms of at least two years and with fixed interest rates is actually eligible for the safe haven. Now, what are the conditions under which this support is in conformity with the safe haven?

[2334] Except for those ECAs of low-income countries (see below Part III, Chapter 4, Section 4.5).

[2335] The Panel observed that Participants disagreed on whether such support is authorized under the OECD Arrangement (Panel Report, *Canada–Aircraft (Article 21.5 – Brazil)*, footnote 90; see also, Wang, Mansilla, Kikuchi, and Choudhury, above n 2032, footnote 5. Export credit support with floating rate loans was (and still is) subject to one of the interest rate provisions. This prohibits the borrower during the life of a loan to switch between the CIRR and a short-term rate, depending on which is lower at a given time. Given that this provision did not contain any minimum interest rule and implied that these transactions were not subject to the CIRR, floating rate loans were not covered by the safe haven (Panel Report, *Canada – Aircraft (Article 21.5 – Brazil)*, footnote 90, paras 5.88, 5.102-5.105).

[2336] Panel Report, *Canada – Aircraft (Article 21.5 – Brazil)*, footnote 91. The Panel highlighted that this had been under discussion for some time among Participants. Yet, the 2010 version of the OECD Arrangement also only stipulates a similar provision on floating rate loans in Article 22(a).

[2337] Panel Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para 5.98 and footnote 85.

Essentially, even though the scope of the safe haven is restricted by the concept of 'interest rate provisions', conformity of export credit practices is not judged merely on the basis of this narrow cluster of provisions.[2338] Indeed, conformity with the safe haven 'must be judged on the basis not only of full conformity with the CIRR but in addition full adherence to the other rules of the *Arrangement* that operate to support or reinforce the minimum interest rate rule by limiting the generosity of the terms of official financing support'.[2339] Consequently, official financing support is justified under the safe haven if it is in conformity with the CIRR as well as with, *inter alia*, the repayment requirement and minimum premium rate (MPR) provisions.[2340]

In case a WTO Member 'matches' the export credit terms provided by other WTO Members, could such support be deemed in conformity with the interest provisions of the OECD Agreement and thus be justified under the safe haven? Several Participants argued before different panels that this question should be answered positively in all cases because matching is allowed under the OECD Arrangement. However, the Panel in *Canada–Aircraft (Article 21.5 – Brazil)* disagreed since it read a distinction between 'permitted exceptions' and derogations in the OECD Arrangement – in particular in the provision on matching.[2341] Permitted exceptions 'refer to certain variations in terms that are foreseen and permitted, subject to limits', while derogations depart from the OECD Arrangement 'in a way not foreseen and not permitted, even within limits, under the plain language of the *Arrangement*'.[2342] Although the Panel recognized that matching of derogations is not prohibited under the OECD Arrangement, 'this does not alter the fact that both the original derogation and the matching remain, by the *Arrangement's* own terms *out of conformity* with the provisions of the *Arrangement*'.[2343] Hence, matching could only be justified under the

[2338] Because other factors also influence the generosity of export credit support (e.g., repayment term). This is also recognized in the OECD Arrangement, since it elaborates several other conditions to official financial support (see above).

[2339] Panel Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para 5.114; Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, para 5.110.

[2340] If applicable, a sector understanding might add specific provisions. An exception should be made in case of interest rate support because such support is not subject to the premium rate obligations. For an elaborated list of covered provisions (under the 1998 version), see Panel Report, *Canada – Aircraft (Article 21.5 – Brazil),* paras 5.115 – 5.119 and Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II),* paras 5.111-5.112 and 5.135-5.205. By linking minimum premium rate provisions to the aspect of 'conformity' instead of considering these as 'interest rate provisions', panels precluded that pure cover support would be covered in the absence of minimum interest rate obligations and, at the same time, ensured that official financing support (except for interest rate support) is only justified if it conforms to the minimum premium rate requirements.

[2341] In the Panel's reading, the provision on matching seemed to make a distinction between matching of credit terms that comply with the OECD Arrangement (thus relying on permitted exceptions) and matching of credit terms that do not comply (thus derogating from the Arrangement).

[2342] Panel Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para 5.121.

[2343] Panel Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para 5.125; Panel Report, *Canada – Aircraft Credits and Guarantees,* para 7.169.

safe haven if the matched export credit support does not derogate from the OECD Arrangement but, instead, makes use of a permitted exception.

Next to the text of the OECD Arrangement, the Panel found support for this view in the context of item (k), para 2, as well as in the object and purpose of the SCM Agreement. Several of these arguments also underpin the Panel's conclusion that pure cover support is currently not eligible for the safe haven. First, a broad reading on matching and pure cover support would put *all non-Participants* at a systematic disadvantage. In contrast to Participants, non-Participants do not have access to information on initial and matched offers derogating from the OECD Arrangement and thus bear a higher burden to match such offers.[2344] Because no information is published on the minimum premium benchmarks, non-Participants should even be presumed to be respecting the minimum premium rules.[2345] Second, a broad reading would particularly disadvantage *developing countries* and therefore be contrary to one of the key stated objectives of the WTO Agreement.[2346] If pure cover support would be eligible for the safe haven without being subject to the interest rate provisions, a *de facto* more favourable treatment of developed countries would occur because of their lower cost of borrowing.[2347] In addition, if matching of derogations would be accepted, developed countries would be allowed to match subsidized offers of developing countries that are not prohibited by virtue of S&D treatment. Third, a broad reading would not fit with the general prohibition of export subsidies under the SCM Agreement.[2348] Allowing pure cover support under the safe haven could result in guaranteed/insured export credits well below the CIRR that would, nonetheless, be justified. Parallel, allowing matching of derogations would justify export credits regardless of how generous the interest rate or other terms would be. This would even mean that WTO Members could justify export credits that match initial offers of non-WTO Members and thus have 'the unheard-of result of allowing WTO Members to opt out of WTO rules on the basis of the behaviour of non-WTO Members'.[2349] In the view of Howse and Neven, this argument is entirely hypothetical because at present no non-WTO Member is Participant to the OECD Arrangement. However, their reasoning overlooks the fact that matching of a derogation is allowed under the OECD

[2344] Panel Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para 5.134. Even if non-Participants could match in case they do not receive the requested information, they are still disadvantaged since, contrary to Participants, they are not informed automatically of non-conforming offers. Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, para 5.117.

[2345] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, footnote 118 and 119.

[2346] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, para 5.135.

[2347] Developing countries would be unable to offer the same level of pure cover support without incurring a cost.

[2348] Export subsidies are prohibited because of their direct trade-distortive effects and, among the various forms of export subsidies, 'subsidized export credits arguably have the most immediate and thus greatest potential to distort trade flows'. Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, para 5.137.

[2349] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, para 5.138.

Arrangement not only against other Participants (which are indeed all WTO Members), but also against non-Participants (which might not be WTO Members).[2350]

In subsequent cases (*Brazil – Aircraft (Article 21.5 – Canada II)* and *Canada – Aircraft Credits and Guarantees*), several OECD Participants voiced the concern that rejecting matching of derogations undercuts the fundamentals of the OECD Arrangement's compliance mechanism.[2351] Indeed, as explained above, adherence to this gentlemen's agreement results from the threat that a non-conforming offer could be matched by other Participants. But again, panels were not convinced that the OECD Arrangement's leeway given to matching should imply that such matching is also allowed under the SCM Agreement. After all, the SCM Agreement is a binding instrument that is enforceable through the WTO dispute settlement mechanism and, as a result, is not dependent on recourse to matching in order to achieve compliance.[2352] Consequently, from the perspective of the SCM Agreement, a (non-)Participant confronted with non-conforming export credit support under the OECD Arrangement could not induce compliance by matching this offer, but has to launch a case before the WTO.[2353]

In response to these panel reports, Participants to the OECD Arrangement exactly did what the Panel in *Canada – Aircraft (Article 21.5 – Brazil)* warned about: change the OECD Arrangement as they see fit.[2354] In particular, they attempted to modify the OECD Arrangement in such a way that future panels would accept matching of derogations. The new provision on matching reads:

[2350] Moreover, Howse and Neven criticize the Panel's argument because, also in case of matching a permitted exception, the conduct of a WTO Member is determined by that of a non-WTO Member. Here, they acknowledge that permitted exceptions are defined and limited by the OECD Arrangement itself but notice that WTO membership is not a prerequisite for becoming a Participant. Non-WTO Members might thus become Participant and be able to modify the OECD Arrangement and thus influence the rights of WTO Members. As they acknowledge, however, it is at present very unlikely that non-WTO Members would become Participant. Furthermore, modification requires consent of all Participants, all of which are today WTO Members. See R. Howse and D. Neven, 'Canada – Export Credits and Loan Guarantees for Regional Aircraft (WT/DS222/R; DSR 2002:III, 849; DSR 2003:III, 1187): A Comment', in H. Horn and P. Mavroidis (eds), *The American Law Institute Reporters' Studies on WTO Case Law – Legal and Economic Analysis* (Cambridge: Cambridge University Press, 2003), 391-401, at 400-401.

[2351] Interestingly, Goldstein and McGuire reveal that Canada might have known that matching Brazil's offer would not be justified under the safe haven and deliberately pursued WTO non-compliance to force an ultimate solution. A. Goldstein and S. McGuire, 'The Political Economy of Strategic Trade Policy and the Brazil – Canada Export Subsidy Saga', 27:4 *The World Economy* (2004), 541-566, at 545. Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, paras 5.113-5.118; Panel Report, *Canada – Aircraft Credits and Guarantees*, para 7.175. Howse and Neven read the latter Panel report as suggesting that the Panel would allow matching of a derogation if it were understood as a permitted form of self-help under the WTO Agreement. However, the Panel's argumentation to reject matching of a derogation seems not be based on its (indeed erroneous) view that the WTO prohibits self-help in all cases (see para 7.170); Howse and Neven, above n 2350, at 399.

[2352] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, paras 5.114-5115; Panel Report, *Canada – Aircraft Credits and Guarantees,* paras 7.175-7.76.

[2353] Of course, this is only possible if both are also WTO Member.

[2354] Panel Report, *Canada – Aircraft (Article 21.5 – Brazil),* para 5.132. See also Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, para 5.87.

> Taking into account a Participant's *international obligations* and *consistent with the purpose of the Arrangement*, a Participant may match, (…), financial terms and conditions offered by a Participant or a non-Participant. Financial terms and conditions provided in accordance with this Article are considered to be in *conformity* with the provisions of Chapter I, II and, when applicable, Annexes I, II, III, IV and X.[2355]

Obviously, the term 'international obligations' indirectly refers to the SCM Agreement. Further, the explicit inclusion that matching of any other offer is consistent with *the purpose* of the Arrangement as well as *in conformity with* its main provisions is a response to the opposite reading by WTO panels. As a result, the textual basis in the OECD Arrangement for the panels' reasoning was completely removed. In addition, the new text of the OECD Arrangement enhances the information available to non-Participants. Participants 'undertake to share information with non-Participants on notifications' and 'shall, on the basis of reciprocity, reply to a request of a non-Participant in a competitive situation on the financial terms and conditions offered for its official support, as it would reply to a request from a Participant'.[2356] However, it seems questionable that these modifications would change the view of future panels. Panels stressed several times that they interpret this question from the standpoint of the SCM Agreement, not from the standpoint of the OECD Arrangement, and their arguments are still valid.[2357] Furthermore, information to non-Participants on non-conforming offers is substantially improved but they are still not placed on an equal footing with Participants.[2358] Therefore, it seems highly doubtful that future panels would allow a reading which a previous panel considered 'simply inconsistent with the overarching principles and purposes of the WTO Agreement and the SCM Agreement'.[2359]

2355 Article 18 of the OECD Arrangement (emphasis added).

2356 Article 4 of the OECD Arrangement. Before the final stage of competition, Participants are not obliged to share information with other Participants on the real terms and conditions offered, as this is seen as part of normal competition between financial institutions. Only if Participants make use of a 'permitted exception' under the OECD Arrangement, prior notification has to be given pursuant to Articles 44 and 45 of the OECD Arrangement. In this case, the new article 4 of the OECD Arrangement thus enables non-Participants in competition for the export sale to be informed beforehand as well.

2357 They emphasize that their view is based on the provisions of the *SCM Agreement* and on 'the need to prevent the scope of the safe haven clause from being improperly enlarged'. Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, paras 5.114-5.115; Panel Report, *Canada – Aircraft Credits and Guarantees*, para 7.176; Panel Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para 5.140. Matching of derogations would still systematically disadvantage developing countries, would be contrary a narrow reading induced from the general prohibition of export subsidies, and would allow non-WTO Members to determine the behaviour of WTO Members.

2358 Mavroidis, Messerlin and Wauters observe that non-Participants have access to information on the export credit terms *offered* but still not on the final terms actually agreed upon. See P. C. Mavroidis, P. A. Messerlin, and J. M. Wauters, *The Law and Economics of Contingent Protection in the WTO* (Cheltenham: Edward Elgar, 2008), 606 pp. at 410. Indeed, non-Participants do not have access to the database collecting final terms of support because this is *ex post* open to Participants only. Admittedly, non-Participants would be less interested in these final terms as the contract is already concluded at that time. Yet, access might still be useful in order to check whether the disciplines of the OECD Arrangement were indeed respected or to know at which terms the competing exporter and ECA won the contract.

2359 Panel Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para 5.140.

On the other hand, the revised OECD Arrangement together with a published Explanation on Premium Rules seems to give sufficient information to non-Participants on the calculation of minimum premium benchmarks.[2360] Consequently, the presumption for non-Participants that their export credit support is in conformity with the minimum premium rate obligations would no longer hold. But export credits benefiting from pure cover support are still not subject to minimum interest rates and would, as a result, still not be considered within the scope of the safe haven by future panels.

4.4. HOW SAFE IS THE SAFE HAVEN: IS NON-PROHIBITED SUBSIDIZED EXPORT CREDIT SUPPORT COUNTERVAILABLE AND/OR ACTIONABLE?

In case official financing support conforms to the interest rate provisions of the latest version of the OECD Arrangement, it is not prohibited under the SCM Agreement.[2361] The text of both paragraph 2 of item (k) and footnote 5 of the SCM Agreement show that such export credit support is exempted from the prohibition on export subsidies. In the Appellate Body's words:

> Under footnote 5 of the *SCM Agreement*, where the Illustrative List indicates that a measure is not a prohibited *export* subsidy, that measure is *not* deemed, for that reason alone, not to be a "subsidy". Rather, the measure is simply *not prohibited* under the Agreement. Other provisions of the *SCM Agreement* may, however, still apply to such a "subsidy".[2362]

This confirms that the subsidy-definition is legally distinct from the exceptions on prohibited export subsidies. As elaborated above, conformity with the OECD Arrangement is *legally* irrelevant to the benefit analysis. Even though the OECD Arrangement is substantially strengthened over time, conformity with this Arrangement will also *de facto* not ensure that no benefit is conferred upon the exporter.[2363] For example, under the current version of the OECD Arrangement, the obligations on premium rates do not guarantee that the buyer/borrower risk will be fully reflected in premium rates if this type of risk is covered.[2364]

[2360] The list of prevailing country risk classifications is published after each meeting on the OECD website. OECD Trade Directorate, above n 2151, at 6.

[2361] With repayment terms of at least two years and with fixed interest rates.

[2362] Other parts of the cited paragraph reveal that those other provisions include the provisions on actionable subsidies (Part III of the SCM Agreement) as well as on the imposition of countervailing measures (Part V of the SCM Agreement). Appellate Body Report, *US – FSC,* para 93 (emphasis in the original). See also Arbitrators, *Brazil – Aircraft (Article 22.6 – Brazil)*, para 3.39.

[2363] Of course, this should be determined on a case-by-case basis. Depending on the market circumstances, it might be the case that export credit support in conformity with the minimum rules of the OECD Arrangement is also available at the private market or that the private market even offers better terms (see also above n 2278). As introduced above, Participants agreed to strengthen this aspect of the OECD Arrangement by introducing a common framework for the pricing of buyer credit risk, which has to be implemented by September 2011 (see above n 2173).

[2364] As elaborated above (n 2173), official support covering country risk as well as buyer/borrower risk merely has to respect the MPR, even though this is only based on the country risk, and the general obligation to cover long-term costs.

But even if only country risk would be covered, it is highly questionable that the private market would provide such cover at the floor rate set in the OECD Arrangement.[2365] Indeed, an IMF study holds that premium rates charged by ECAs are not directly comparable to private premium rates as the private sector often does simply not offer the type of cover available through ECAs.[2366] Such support would, nonetheless, be considered a specific subsidy under the SCM Agreement (private market test). The OECD Arrangement aims at leveling the playing field among ECAs, not directly between ECAs and the private sector.[2367] Hence, OECD Arrangement-conforming export credits by ECAs that are justified on the basis of the safe haven, might – *de jure* and *de facto* – still be a 'subsidy' within the meaning of Article 1 of the SCM Agreement.

Are such non-prohibited but subsidized export credits safe from any other unilateral or multilateral challenge, given that footnote 5 and paragraph 2 of item (k) only stipulate that they are not *prohibited* under the SCM Agreement? As the Appellate Body observed, other provisions of the SCM Agreement may still apply to a 'subsidy' within the meaning of Article 1 of the SCM Agreement.[2368]
First, this observation reveals how subsidized export credits offered in accordance with the OECD Arrangement can, just as all other specific subsidies, be countervailed if they cause injury to a Member's domestic industry.[2369] As indicated, under the Subsidies Code, the EC disagreed that OECD-conforming export credits could still qualify as subsidies and thus be countervailed. Apparently, the EC seems to stick to this view even though the SCM Agreement, by including a separate subsidy-definition, leaves no doubt that it is erroneous.[2370]

[2365] As elaborated above (n 2173 and 2174), in case only country credit risk is covered, the MPR is reduced by 10%. The OECD Arrangement stipulates that an amount in surplus to the MPR should be charged for the highest risk countries but leaves it up to Participants to define the exact amount as long as no cost to the government is incurred. Moreover, in case of export credits for certain transactions covered by sectoral understandings, there are no disciplines on premium rates in place (e.g., ships).
[2366] Wang, Mansilla, Kikuchi, and Choudhury, above n 2032, at footnote 7.
[2367] To be sure, an indirect motivation for strengthening disciplines under the OECD Arrangement is to prevent crowding out (or inhibition) of the private trade finance sector.
[2368] Appellate Body Report, *US – FSC*, para 93.
[2369] Articles 10 (footnote 36), 11.2 and 19.1 of the SCM Agreement. Evidently, CVDs can only offset the injury in the domestic market and are an inefficient instrument to respond to export credits offered by other ECAs to foreign buyers in third countries. CVDs are effective in case domestic producers have to compete for domestic sales with foreign producers backed with subsidized export credits.
[2370] In the *Farmed Atlantic Salmon* investigation, the CVD investigation had concluded that the programme was in accordance with the OECD Arrangement and thus justified under item (k), para 2 of the Illustrative List. Because the programme did not incur a cost to the government, it was considered not countervailable. This conclusion was not explicitly (or certainly not exclusively) derived from the fact that the programme was in accordance with the OECD Arrangement. Evidently, WTO Members can adopt a narrower view on which subsidies they would countervail but under EC law, the Basic Regulation defines countervailable subsidies similar as under the SCM Agreement. *Council Regulation (EC) No 1891/97 of 26 September 1997 imposing a definitive countervailing duty on imports of farmed Atlantic salmon originating in Norway, (1997) OJ L267/19*, para 75. Implicitly, the view that OECD-conform export credits cannot be countervailed seemed to be endorsed in the *Council Regulation (EC),*

Second, a more difficult question is whether OECD Arrangement-conforming export credit support, though not prohibited, could still be challenged as 'actionable subsidies'.[2371] At first sight, this option might be rejected on the basis of footnote 5 since its text indicates that such export credit support 'shall not be prohibited under this *or any other provision of the Agreement*'.[2372] By its terms, not only Article 3.1(a) (*juncto* the Illustrative List) is thus considered to 'prohibit' subsidies, but other provisions of the SCM Agreement could have that potential as well. The provisions on actionable subsidies are prime candidates to fall within this group, as they are, next to those on prohibited subsidies, the only other disciplines imposing restrictions on subsidization.[2373] Moreover, the case law contains some statements suggesting a broad interpretation of footnote 5. The Appellate Body held that if an exception under the Illustrative List is demonstrated, 'a Member is entitled to adopt it' and, according to the Panel in *Brazil – Aircraft (Article 21.5 – Canada)*, that it would be 'permitted'.[2374]

On the other hand, several strong arguments could be advanced that OECD Arrangement-conforming official export credit support could still be actionable. Article 5 of the SCM Agreement on actionable subsidies does certainly not exclude this option and this reading might find some confirmation in the negotiating history as well.[2375] The Panel in *Korea – Commercial Vessels* also decided that:

> Nothing in the SCM Agreement precludes claims being brought under both Parts II and III in respect of the same measures. Thus, to the extent that a complaining Member is able to demonstrate that a measure is a prohibited export subsidy that causes adverse effects to the interests of other Member, we see no reason why simultaneous findings could not be made under both Articles 3 and 5 of the SCM Agreement in respect of that measure.[2376]

No 1599/1999 of 12 July 1999 (…) terminating the proceeding concerning imports of stainless steel wires (…) originating in the Republic of Korea, (1999) OJ L/189, para 56.

[2371] Members could show that subsidized export credits, for example, cause injury to their domestic industry or displace/impede their exports to the subsidizing country or a third country (Article 5(a) and 5(c) *juncto* 6.3 of the SCM Agreement).

[2372] Emphasis added.

[2373] If this would only have referred to local content subsidies, drafters arguably would have been more specific. Additionally, an argument could be made that local content subsidies might even not be covered by this reference in footnote 5, since local content subsidy claim would scrutinize aspects of the measure different those examined under an export subsidy claim (see below n 2403).

[2374] The Appellate Body based its reasoning on the text of footnote 59 (on avoiding double taxation) but, in this way, also indirectly interpreted the scope of footnote 5. The Appellate Body did not explicitly qualify its statement in such a way that the subsidy would only justified insofar it would cause adverse effects to the interest of other Members. Appellate Body Report, *US – FSC (Article 21.5 – EC)*, paras 132-133; Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, paras 6.33 and 6.41.

[2375] Article 5 of the SCM Agreement prescribes that 'no Member should cause, through the use of *any subsidy referred to in paragraphs 1 and 2 of Article*, adverse effects to the interests of other Members' (emphasis added). The Subsidies Code also stated, in Article 8, that '(…) 2. Signatories agree not to use *export subsidies* in a manner inconsistent with the provisions of this Agreement. 3. Signatories further agree that they shall seek to avoid causing, through the use of *any subsidy* [injury to the domestic industry, nullification or impairment of benefits and serious prejudice] (…)' (emphasis added).

[2376] Panel Report, *Korea – Commercial Vessels*, para 7.334.

This Panel rejected that Part II and Part III exhaustively deal with specific types of subsidies, namely export/local content subsidies and all other types of specific subsidies.[2377] Hence, export subsidies could be challenged under Part III on actionable subsidies and, in this respect, the analysis under the safe haven seems to be irrelevant.[2378] Moreover, strictly speaking, subsidies causing adverse effects are not prohibited under the SCM Agreement as the implementing Member has the option to withdraw the subsidy itself *or* its adverse effects.[2379] Indeed, the only types of 'prohibited subsidies' (Part II) are export subsidies and local content subsidies. As a result, an interpretation opening the door to an actionable subsidy claim would not contradict footnote 5 of the SCM Agreement. In addition, deciding otherwise would imply that some subsidies contingent upon exportation would be non-actionable whereas all domestic subsidies are actionable if causing adverse effects. This might be hard to reconcile with the stricter stance on export subsidies under the SCM Agreement. It would also mean that injury caused by such subsidies to the domestic industry could be countervailed (unilateral option), but not be challenged before a panel (multilateral option). Finally, the Appellate Body's statement that 'the measure is simply *not prohibited* under the Agreement' and 'other provisions of the *SCM Agreement* may, (…), still apply to such a "subsidy"' is also supportive of the conclusion that exceptions under the Illustrative List might still fall within the category of actionable subsidies.[2380] Overall, the case law thus seems to incline to the narrow reading of footnote 5, which would imply that export credit support in accordance with the safe haven could still be challenged as an 'actionable subsidy' and will have to be withdrawn, or at least its adverse effects will have to be taken away, in case it causes adverse effects to the interest of other WTO Members. Whether or not this seriously curtails the safe haven depends on the additional burden of proof put on the shoulders of the complaining party to demonstrate that such support caused one of the listed types of 'adverse effects' in Article 5 of the SCM Agreement.[2381]

[2377] Thus, the fact that specific procedures are in place to challenge 'prohibited' and 'actionable' subsidies does not imply that they exhaustively deal with specific types of subsidies. This aspect might also find confirmation in the S&D treatment provisions (see above Part II, Chapter 6, Section 6.1.2; below Part III, Chapter 4, Section 4.5).

[2378] Even Korea as defendant acknowledged that '(f)ootnote 5 provides that excepted measures under Annex I are not "prohibited subsides"; it does not use the broader term "non-actionable subsidies" as is found in Article 8.1. Therefore, such subsidies could still be considered under Part III or Part V'. See Panel Report, *Korea – Commercial Vessels*, Second Written Submission of Korea (Annex E2), para 21.

[2379] Article 7.8 of the SCM Agreement.

[2380] As noted above (n 1070), these other provisions seem to include the provisions on actionable subsidies (Part III of the SCM Agreement). Appellate Body Report, *US – FSC*, para 93 (emphasis in the original). This reading is also adopted by G. Luengo, *Regulation of Subsidies and State Aids in WTO and EC Law* (The Netherlands: Kluwer Law International, 2006), 586 pp., at 152; K. Adamantopoulos and V. Akritidis, 'Agreement on Subsidies and Countervailing Measures (SCMA) – Article 3 SCMA', in R. Wolfrum, P-T. Stoll and M. Köbele (eds), *Max Planck Commentaries on World Trade Law: WTO – Trade Remedies* (Leiden: Martinus Nijhoff Publishers, 2008), 471-486, at 483.

[2381] For example, the complaining party could demonstrate 'serious prejudice' on the basis of the fact that the export credit support's effect is 'to displace or impede the exports of a like product of another

4.5. EXCEPTION ON THE EXPORT SUBSIDY PROHIBITION FOR SOME DEVELOPING COUNTRIES

The SCM Agreement recognizes that 'subsidies may play an important role in economic development programmes of developing country Members' and therefore gives flexibility to developing countries on subsidization.[2382]

At present, an exception to the prohibition on export subsidies relevant for export credit support is in place for two types of developing countries listed in Annex VII of the SCM Agreement[2383]: (i) least-developed countries (LDCs)[2384] and (ii) some other low-income countries recited in item (b) of Annex VII of the SCM Agreement until their GNP per capita has reached $1000 per annum.[2385] Despite this exception, their export subsidies will have to be phased-out within 8 years for those products in which they have reached export competitiveness.[2386] Moreover, their subsidized export credits can still be challenged as 'actionable subsidies'.[2387] Alternatively, other WTO Members could opt for the unilateral response if confronted with injury to their domestic industry.[2388] The only additional burden for imposing these CVDs against developing countries is that the *de minimis* standard is higher.[2389]

Interestingly, the Panel in *Brazil – Aircraft* recognized that export subsidies, including subsidized export credits that were at stake in that case, could be consistent with development needs of developing countries: it '(…) might be interested in the possible technological spin-off effects from the development and production of the product in question, or the need to establish a strong market presence and reputation in foreign markets as a stepping stone to

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Member from a third country market' (Article 6.3 of the SCM Agreement). See above Part II, Chapter 4, Section 4.2.3.

[2382] Article 27.1 of the SCM Agreement. See above Part II, Chapter 6, Section 6.1.1.1.

[2383] The remaining S&D treatment for certain small trading developing countries (Article 27.4 of the SCM Agreement) is not applicable with regard to export credit support because they only benefit from S&D treatment on exemptions from import duties and internal taxes (see below n 2391).

[2384] Annex VII of the SCM Agreement. LDCs are designated by the United Nations.

[2385] The threshold is raised to $1000 in constant 1990 dollars for three consecutive years. The country will be re-included when it falls back below $1000. See Ministerial Conference, *Implementation – Related Issues and Concerns* (WT/MIN(01)/17, 14 November 2001), paras 10.1 and 10.4. Three countries have graduated so far (i.e., Dominican Republic, Guatemala, and Morocco). See Table 1 above Part II, Chapter 6, Section 6.1.1.1.1.

[2386] Article 27.5 of the SCM Agreement. Such export competitiveness was established for India with respect to textiles (see above Part II, Chapter 6, Section 6.1.1.1.3).

[2387] Article 27.7 of the SCM Agreement. This might be an additional argument why OECD-conforming export credit support of developed countries should still be actionable. Otherwise, OECD-conforming official financing support of developed countries would be non-actionable while export credit support given by developing countries benefiting from S&D treatment is actionable under certain conditions without the option to invoke the OECD Arrangement. Alternatively, if the extensive reading of footnote 5 would be adopted, developing countries benefiting from S&D should be allowed to invoke the safe haven when confronted with a claim under 'actionable subsidies'.

[2388] For the application of CVDs, no differentiation is made among developing countries.

[2389] Article 27.10 of the SCM Agreement.

introducing products with greater national value-added'.[2390] Thus, in the Panel's view, export credit support could be a useful development tool not only to correct information/capacity market failures in the capital market but also as an instrument for export promotion. At present, however, the prohibition on export subsidies is applicable to all developing countries not listed in, or which graduated from, Annex VII.[2391] The gradual prohibition of export subsidies for these countries is one of the main novelties of the SCM Agreement.[2392] Similar as for developed countries, they have to justify subsidized export credit support on the basis of the interest rate provisions of the OECD Arrangement, even though they are not involved in its revisions as non-Participants.[2393]

4.6. EXPORT CREDIT SUPPORT AS LOCAL CONTENT SUBSIDY

So far, our discussion has totally neglected one particular aspect of the export credit support transaction. Under what conditions are exporters exactly eligible to receive export credit support and how much foreign support content could be supported? Because this aspect of the export credit transaction is not disciplined under the OECD Arrangement, countries have different criteria addressing this issue in place. The US Ex-Im Bank has elaborated the most restrictive foreign content policies among all G-7 countries. Therefore, the following analysis will scrutinize whether this legal regime is actually in conformity with the US WTO obligations.[2394]

To be eligible for medium- and long-term export credit support of the US Ex-Im Bank, goods and services must be *shipped* from the US to a foreign buyer. All goods and services in the supply contract shipped from the US are eligible, even when they were in part (i.e., components) or in full produced abroad previously. This means that to be eligible for such medium- and long-term financing, no minimum amount of domestic content is required. However, the total level of support for a supply contract will be the lesser of: (a) 85% of the value of all eligible goods and services in the US supply contract; *or* (b) 100% of the US content in all eligible goods and services in the US supply contract. As a result, *only* US content in the supply contract will be supported: if no US content is included, no support will

[2390] Panel Report, *Brazil – Aircraft*, para 7.92.
[2391] They were subject to a standstill obligation during a phase-out period which lapsed in 2003 and no extensions were provided on export credit support. See article 27.4 of the SCM Agreement and SCM Committee, *Procedures for extensions under Article 27.4 for certain Developing Country Members* (G/SCM/39, 20 November 2001); General Council, *Article 27.4 of the Agreement on Subsidies and Countervailing Measures* (WT/L/691, 31 July 2007).
[2392] Those offered by developed countries were already disciplined under the Subsidies Code.
[2393] Except for Brazil with respect to the Sector Understanding for Civil Aircraft.
[2394] This legal regime is described in Export-Import Bank of the US, *Foreign Content Policy for Medium- and Long-Term Exports* (available at: http://www.exim.gov/products/policies/foreign_medium-long.cfm); Export-Import Bank of the United States, above n 2045, at 69-72.

be given and US content is supported up to 85% of all eligible goods and services.[2395] This overall ceiling reflects the OECD Arrangement's obligation that official support should not exceed 85% of the supply contract.

Suppose by way of example the financing of a telecommunications project with a $10.7 million supply contract (see Table 1), involving $9 million US content and $1.7 million foreign content of which $1 million is shipped from the US. The fraction of the supply contract eligible for export credit support is $10 million. Given that the share of US content is above the 85% ceiling, $8.5 million is the total level that will be supported.[2396] In case US content would only have been $7 million and foreign content shipped from the US $3 million, the total level of support would have been $7 million. This illustrates that the level of support starts decreasing once the share of foreign content shipped from the US is higher than 15% (so-called 15% 'foreign content allowance'). Only for 15% of the eligible sales contract is the exporter indifferent between sourcing locally or importing.

Goods/services in supply contract	US content	Foreign content shipped from the US	Foreign content not shipped from the US
Computers	4,000,000	500,000	0
Antennas	3,00,000	0	600,000
Transmitters	2,000,000	500,000	100,000
Total	**9,000,000**	**1,000,000**	**700,000**
US supply contract	10,700,000		
Eligible US supply contract	10,000,000		
Level of support	8,500,000		

TABLE 1: HYPOTHETICAL EXAMPLE OF US SUPPLY CONTRACT[2397]

However, are these conditions not in violation with the prohibition on local content subsidies spelled out in Article 3.1(b) SCM Agreement?[2398] As explained in this study's Part II, local

[2395] As an exception, US Ex-Im Bank could next to *US* content also offer local cost support up to 30% of the *eligible* US supply contract. Local costs are 'expenditures for goods and services *in the buyer's country* that are necessary either for executing the exporter's contract or for completing the project of which the exporter's contract forms a part' (Annex XI, item (j) of the OECD Arrangement). The OECD Arrangement allows such support for local cost up to 30% of the export contract value (Article 11 of the OECD Arrangement). 'Ancillary service fees' could under certain conditions and limitations receive financing as well. Contrary to local costs, these service providers do not necessarily have to originate in the buyer's country. Depending on the way these are structured, such fees are either considered part of US content or part of local cost.

[2396] Moreover, 'local costs' could be supported if, for example, a subsidiary of the US exporter is responsible for installing the telecommunication project in the buyer's country. A maximum of $1.5 million local costs could be supported (see above n 2395) in addition to $8.5 million US content. Yet, if the US exporter itself provides the service in the buyer's country, this is considered as US content. The threshold question is whether the service provider pays taxes under the US law: if this is the case, it is considered as US content.

[2397] This example is partly based on an example given by the Ex-Im Bank (above n 2394).

content subsidies are conceptually different from other subsidies as they target trade distortion in the input industry and not in the market of the industry receiving the subsidy. Applied to export credit support, it should thus be demonstrated that it qualifies as a subsidy to the exporter in the meaning of the SCM Agreement (on the basis of Article 1 *juncto* 3 or the Illustrative List). If this subsidy, which is deemed to be specific (Article 2.3 SCM Agreement), is 'contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods', it would in principle be prohibited under the SCM Agreement.[2399] The criteria set by the US Ex-Im Bank for medium and long-term credits are clearly 'contingent' upon the use of domestic goods given that *no* support would be given without domestic content and *only* domestic content is supported.[2400] Indeed, only those parts and components (upstream industry) of the exported product (downstream industry) having US origin are supported. Turning back to our example, the imported components (e.g., hard disks) used for assembling the computers in the US are 'foreign content', for which the foreign buyer of computers will thus not receive export credit support from the Ex-Im Bank.[2401] Or, if the Ex-Im Bank would support an export sale of a Boeing airplane, only those parts and components (e.g., engines) produced in the US will be supported. Thus, an exporter has a strong incentive to buy locally as only this amount will be eligible for export credit support in the end.[2402]

Hence, are such subsidized export credits provided by the US Ex-Im Bank prohibited on the basis of the Article 3.1(b), because they qualify as local content subsidies? For those subsidized export credits not covered by the safe haven, the answer would be affirmative but the practical relevance might be low. Indeed, such subsidized export credits (e.g., pure cover

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2398 Recall that the panel and Appellate Body also considered that local content subsidies to agricultural products are prohibited under Article 3.1(b) of the SCM Agreement (see above Part II, Chapter 6, Section 6.2.3.1). In theory, export credit support to agricultural products having similar local content conditions in place could be challenged similarly under the SCM Agreement but such support is mostly short-term in nature. Moreover, such support could not be exempted on the basis of the safe haven as it falls outside the scope of the OECD Arrangement.

2399 This encompasses *de jure* as well as *de facto* contingency. Appellate Body Report, *Brazil – Aircraft*, paras 135-143.

2400 On the interpretation of 'contingency' under Article 3.1(a) and (b), see above Part II, Chapter 4, Section 4.1.

2401 Hence, domestic assembly of the foreign inputs does not transform the foreign-originated input to domestic content.

2402 This reasoning does not mean that export credit support (or other subsidies) given to domestic products is *ipso facto* contingent upon the use of domestic over imported goods. Such reasoning would be at odds with the SCM Agreement as this allows, under certain conditions, subsidization of domestic products. Rules of origin determine under what conditions a product could be considered a 'domestic' product. Yet, local content rules do not imply that only domestic inputs are supported. Consider, for example, a subsidy given to Boeing. This would not be considered a local content subsidy simply because a certain amount of local inputs has to be used in order to qualify as a US aircraft. In contrast, a local content subsidy might exist if only those parts of a 'US aircraft' that are effectively produced domestically are subsidized. The latter is the case under the US Ex-Im Bank criteria for medium- and long-term support.

support at below market terms) are already prohibited as an export subsidy. On the other hand, subsidized export credits covered by the safe haven will, pursuant to footnote 5, not be 'prohibited (…) under any other provision of this Agreement' and, as a result, shall probably not be prohibited as local content subsidies.[2403] Nevertheless, as argued above, this footnote does not exempt those subsidies from scrutiny under the actionable subsidy category (or from CVDs action). More important, the scope of footnote 5 is explicitly limited to 'this Agreement' and, for that reason, does not shield those non-prohibited subsidies from scrutiny under other WTO Agreements. Consequently, OECD Arrangement-conform subsidized export credits could, if contingent upon the use of domestic goods, be challenged on the basis of Article III:4 of the GATT and the TRIMs Agreement.

First, these subsidies seem to violate the GATT's national treatment provision (Article III:4) because the regulations at hand discriminate between domestic and foreign input-supplying industry. The exception for subsidies to domestic producers (Article III:8(b) of the GATT) is not applicable since the discrimination exists between the domestic and foreign input industries and not between the subsidized industry and the foreign industry.[2404] Domestic input producers are treated favorably, not because they receive a subsidy themselves but because the exporter receives a subsidy contingent upon the use of their inputs.

Second, local content subsidies seem to be covered under the Illustrative List of the Agreement on Trade-Related Investment Measures (TRIMs) that are inconsistent with Article III:4 of the GATT (as local content requirements).[2405] The Ex-Im Bank justifies its eligibility and foreign content criteria by referring to its mandate 'to maintain or increase US employment through the financing of US exports'.[2406] Hence, these criteria for receiving official export credit support could be considered investment measures.[2407] Such investment measures are inconsistent with Article III:4 of the GATT in case 'compliance with which is necessary to obtain an advantage' (e.g., export credit support) and which require 'the purchase or use by an enterprise of products of domestic origin or from any domestic source' (e.g., eligible criteria).[2408] In sum, even if OECD Arrangement-conform export credits are in

[2403] The text of footnote 5 thus seems to exclude that such export credit support would be prohibited as a local content subsidy. On the other hand, one might object that the focus of local content subsidies is on the discrimination between domestic and foreign inputs and conformity of the export transaction with the OECD Arrangement is not directly relevant in this respect. It would only be relevant if OECD Arrangement-conforming export credit support would *ipso facto* be extended at commercial terms but this assumption is not fulfilled. If that would be the case, there would be no subsidy given to the exporter and thus no extra incentive to buy local inputs instead of imported ones.

[2404] GATT Panel Report, *Italy – Agricultural Machinery*, para 14; Panel Report, *Indonesia – Autos*, para 14.43.

[2405] See Article 2 of the TRIMs Agreement *juncto* paragraph 1 of the Illustrative List of the TRIMs Agreement.

[2406] Export-Import Bank of the United States, above n 2045, at 69.

[2407] Article 1 of the TRIMs (no definition of investment is provided).

[2408] Paragraph 1 of the Illustrative List of the TRIMs Agreement.

accordance with the SCM Agreement, they could nonetheless be in violation with Article III:4 of the GATT and Article 2 of the TRIMs Agreement if they have eligibility criteria in place that discriminate between local and foreign input industry.[2409,2410]

Although these foreign content criteria thus seem WTO-inconsistent, the impetus for relaxing these requirements might rather come from *within* the US. Indeed, the 2009 Report of the US Ex-Im Bank shows that ECAs of other G-7 countries are gradually implementing more flexible foreign content criteria (e.g., increasing maximum foreign content allowance). Hence, they shift from the 'made *in* country X' approach to the 'made *by* country X' approach.[2411] It allows these ECAs to support foreign content (e.g., produced by foreign subsidiaries of domestic 'champions') so long as the overall transaction is considered beneficial to the 'national interest'.[2412] Hence, US exporters complained that they no longer competed on a level playing field with exporters of other G-7 countries as those exporters could receive support at similar financing terms but with less local content requirements in place. As they are restricted from purchasing from the most efficient upstream producer to receive the same amount of support, US exporters considered Ex-Im Bank's foreign content policy 'the biggest challenge' for its competitiveness vis-à-vis other ECAs.[2413]
This reveals an interesting friction between the interests of exporters (e.g., 'national champions') and the Ex-Im Bank's mission to support US employment. Similar to the dynamics of tariff negotiations, the trade distortion created by the government in the upstream

[2409] Note that these provisions can in theory still be justified on the basis of the general exceptions (Article XX of the GATT and Article 3 of the TRIMs) or balance-of-payments exception (Articles XII and XVIII:B of the GATT and Article 4 of the TRIMs).
[2410] The same conclusion holds when such criteria would be installed for export credit support offered by developing countries. First, there are currently no S&D treatment provisions on the prohibition of local content subsidies in force (Article 27.3 of the SCM Agreement). As a result, a developing country (including LDCs) whose subsidized export credit system is challenged on the basis of the prohibition of local content subsidies (3.1(b)), will have to justify its support on the basis of the OECD Arrangement (footnote 5 of the SCM Agreement *juncto* para 2 of item (k) Illustrative List). If successful, the subsidized export credit support is not prohibited under the SCM Agreement. Yet, local content criteria can also be challenged under Article III.4 GATT and Article 2 TRIMs, with the exception for those LDCs still benefiting from relevant S&D treatment under TRIMs to introduce such type of support.
[2411] Export-Import Bank of the United States, above n 2045, at 69-72.
[2412] An interesting question is how the part of export credit support for products produced abroad (and not shipped from the ECAs' country) would be disciplined under the SCM Agreement. The basic thrust of the disciplines on export subsidies is to inhibit countries' reflex to subsidize their exports produced domestically ('made *in* country X'). Apparently, some countries are more and more willing to support their 'national champions', even if they partly produce abroad, as long as it benefits their overall 'national interest' ('made *by* country X'). Unless this 'national interest' merely covers these national champions' interests and would thus result from their political-economy efforts, this assumes that the spillovers of the production remaining in the home country are deemed sufficiently high to offer such support (or such support might result from political-economy efforts).
[2413] Export-Import Bank of the United States, above n 2045, at 72. The fact that, despite the stringent local content requirements, US exporters still opt for US Ex-Im Bank export credit support illustrates that this support is extended at better-than-market terms conditions.

industry (e.g., local content requirements) might thus shrink because of internal pressure from the domestic downstream industry.

5. DISCIPLINES ON EXPORT CREDIT SUPPORT FOR AGRICULTURAL PRODUCTS

In this section, the policy space given to WTO Members to offer export credit support for agricultural products is explored. The scope of the present disciplines was delineated by the panels and Appellate Body in the *US – Upland Cotton* cases. Before the *US – Upland Cotton* rulings, it was not even clear whether any substantive discipline was in place on such support. In this dispute, Brazil challenged the operation of the US export credit programmes with regard to upland cotton as well as to a number of other agricultural products, all of which qualified as 'agricultural products' under Annex I of the Agreement on Agriculture.[2414] Because Brazil formulated claims under both the Agreement on Agriculture and the SCM Agreement, a preliminary question addressed the precise Agreement under which the programmes had to be analyzed first.

By virtue of Article 21.1 of the Agreement on Agriculture, other multilateral agreements on trade in goods 'shall apply subject to the provisions of this Agreement'.[2415] This provision thus provides for the application of the SCM Agreement[2416] but likewise implies that the latter only applies 'except to the extent that the Agreement on Agriculture contains specific provisions dealing specifically with the same matter'.[2417] Furthermore, Article 3.1 of the SCM Agreement prohibits export subsidies 'except as provided in the Agreement on Agriculture', which according to the Appellate Body means that 'the WTO-consistency of an export subsidy for agricultural products has to be examined, in the first place, under the Agreement on Agriculture'.[2418]

As a result, the Panel in *US – Upland Cotton* first analyzed the claims on export credit support for agricultural products under the Agreement on Agriculture.[2419] To be sure, the SCM Agreement already offered important guidance in interpreting the concept of an export subsidy under the Agreement on Agriculture.[2420] Once the analysis under the Agreement on

[2414] In the original procedure, Brazil challenged three such programmes: the GSM 102, the GSM 103, and the Supplier Credit Guarantee Programme (SCGP). Because the latter two were repealed, the central claim before the compliance panel was whether the operation of the revised GSM 102 was still inconsistent with the Agreement on Agriculture and the SCM Agreement.
[2415] Emphasis added.
[2416] Panel Report, *US – Upland Cotton*, para 7.257.
[2417] Appellate Body Report, *US – Upland Cotton*, para 532; Appellate Body Report, *EC – Bananas III*, para 155; Appellate Body Report, *Chile – Price Band System*, para 186.
[2418] Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US)*, para 123.
[2419] Panel Report, *US – Upland Cotton*, paras 7.251-7.262. See also Panel Report, *Canada – Dairy*, paras 7.18-7.23; Panel Report, *EC – Export Subsidies on Sugar*, para 7.101.
[2420] In the words of the Appellate Body: '(a)lthough an export subsidy granted to agricultural products must be examined, in the first place, under the *Agreement on Agriculture*, we find it appropriate, as has the Appellate Body in previous disputes, to rely on the *SCM Agreement* for guidance in interpreting provisions of the *Agreement on Agriculture*'. Appellate Body Report, *US – Upland Cotton*, para 571. See also Panel Report, *Canada – Dairy*, para 7.23. The Panel cited the Appellate Body's statement in *Brazil – Desiccated Coconut*: 'with respect to subsidies on agricultural products … (t)he *Agreement on Agriculture* and the *SCM Agreement* reflect the latest statement of WTO Members as to their rights and obligations concerning agricultural subsidies'.

Agriculture was finished, the question on the applicability of the SCM Agreement to export credit support for agricultural products emerged. The same order of analysis is adopted in our discussion.

5.1. EXPORT CREDIT SUPPORT FOR AGRICULTURAL PRODUCTS UNDER THE AGREEMENT ON AGRICULTURE

As explained in detail in Part II, the Agreement on Agriculture does not install a principle prohibition on export subsidies. In disciplining agricultural export subsidies, the Agreement on Agriculture draws a distinction between listed types of export subsidies (Article 9 of the Agreement on Agriculture) on the one hand, and all other types of export subsidies (Article 10 of the Agreement on Agriculture) on the other hand.

Concerning the listed types of export subsidies in Article 9 of the Agreement on Agriculture, WTO Members having scheduled agricultural products are allowed to support these products with these listed forms of export subsidies, but only up to their reduction commitments. Hence, the six listed types of export subsidies could not be offered to unscheduled agricultural products and to scheduled agricultural products above reduction commitment levels. This means that WTO Members that have not scheduled any agricultural product could in principle not offer listed-types of export subsidies at all. Yet, an exception for developing countries is in place with regard to two types of export subsidies. By virtue of Article 9.4 of the Agreement on Agriculture, developing countries are allowed to grant marketing and transport export subsidies as long as these are not applied in a way that would circumvent their reduction commitments.[2421]

Export credit support is, however, not among these listed types of export subsidies in Article 9. Only Article 10.2 of the Agreement on Agriculture explicitly deals with export credit support and stipulates an obligation on WTO Members to work toward the development of multilateral disciplines. Since no such disciplines have been drafted so far, the pivotal question presented in the *US – Upland Cotton* case was whether export credit support is already subject to the general anti-circumvention obligation imposed on non-listed export subsidies (Article 10.1 of the Agreement on Agriculture). In order to find a violation of Article 10.1, two elements have to be established: (a) the presence of 'export subsidies not listed in paragraph 1 of Article 9'; (b) 'applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments'. Both elements are examined consecutively.

[2421] On the scope and content of this exception, see above Part II, Chapter 6, Section 6.2.1.2.1.2.

5.1.1. Scope: Export subsidies not listed in paragraph 1 of Article 9 of the Agreement on Agriculture

5.1.1.1. Is subsidized export credit support covered by Article 10.1 of the Agreement on Agriculture?

Export credit support for agricultural support is only covered insofar it qualifies as an 'export subsidy' in the meaning of Article 10.1. The following section discusses the determination of whether export credit support is effectively offered at subsidized terms. Assuming that this condition is fulfilled, such support at face value seems to fall within the scope of Article 10.1 as it is an export subsidy 'not listed in paragraph 1 of Article 9'.[2422] Nonetheless, the US argued before the original Panel and Appellate Body in *US – Upland Cotton* that export credit support is not covered under the term 'export subsidies' of Article 10.1 since it would be exempted thereof by virtue of paragraph 2 of Article 10.[2423] This provision reads:

> Members undertake to work toward the development of internationally agreed disciplines to govern the provision of export credits, export credit guarantees or insurance programmes and, after agreement on such disciplines, to provide export credits, export credit guarantees or insurance programmes only in conformity therewith'.

As disentangled by the Appellate Body, two types of obligations are imposed upon WTO Members with respect to export credit support under this paragraph: (i) working toward the development of internationally agreed disciplines to govern their provision; and (ii) after agreement on such disciplines, to provide them only in conformity therewith.[2424] To date, no such disciplines have been agreed upon and no substantive obligations are thus currently in place by virtue of Article 10.2. Yet, the Appellate Body agreed with the Panel that paragraph 2 does not carve out export credit support from the scope of paragraph 1. In a rare separate opinion, however, one Appellate Body Member adhered to the US view mainly because the fact that WTO Members chose to deal with export credit support under Article 10.2 'shows that this special treatment (…) must be given meaning and weight'.[2425] Applying the customary rules of treaty interpretation, the Appellate Body offered the following arguments to underpin its conclusion.

First, starting with the ordinary meaning, the Appellate Body stressed that paragraph 2 does not explicitly exclude export credit support from the disciplines in Article 10.1 whereas 'it

[2422] By its terms, only export subsidies not listed in Article 9 are covered by Article 10.1. See, for example, Appellate Body Report, *US – FSC*, para 142; Appellate Body Report, *US – Upland Cotton*, para 615.

[2423] The Appellate Body was 'stuck by the fact' that the Panel only addressed this argument of the US at the end of its analysis (i.e., after having analyzed whether export credit support was subsidized or not). Appellate Body Report, *US – Upland Cotton*, para 628.

[2424] Appellate Body Report, *US – Upland Cotton*, para 607.

[2425] Appellate Body Report, *US – Upland Cotton*, paras 631-641. Observe that several authors as well as the OECD Secretariat also shared the US view, whereas the WTO Secretariat seemed to have taken another position (see above n 2164). See also, Panel Report, *US – Upland Cotton*, WT/DS267/R/Add.1, Part 3, at D-29.

would be expected that an exception would have been clearly provided had this been the drafters' intention'.[2426] The wording 'development' also suggests that future disciplines will be 'an elaboration of the export subsidy disciplines that are *currently* applicable', which means that the mandate of Article 10.2 will not be irrelevant if such support would also be disciplined under paragraph 1.[2427] On the other hand, as the dissenting Appellate Body Member argued, the wording 'to work *toward* the development' might likewise suggest that no disciplines yet exist.[2428] The dissenting Member saw some confirmation in the phrase that only '*after* agreement on such disciplines' export credit support shall be provided in conformity therewith.[2429]

Second, the Appellate Body found contextual support in Article 10.1 *juncto* Article 1(e) of the Agreement on Agriculture. A plain reading of Article 10.1 would only exclude export subsidies listed in Article 9.1. Moreover, the term 'export subsidies' is defined in Article 1(e) as 'subsidies contingent upon export performance, *including* the export subsidies listed in Article 9'[2430] and, according to the Appellate Body, 'the use of the word "including" suggests that the term "export subsidies" should be interpreted broadly'.[2431] One could object that the ordinary meaning of 'including' merely indicates that Article 9.1 is not an exhaustive list but not necessarily that the group of non-listed export subsidies should be interpreted broadly.

Third, the Appellate Body referred to the object and purpose of Article 10 which is – as its title suggests – 'the prevention of circumvention of export subsidy commitments'.[2432] The US view would undermine this objective as it would imply that export credit support is currently 'subject to no disciplines *at all*'.[2433] The dissenting Member equally disagreed on this point because Article 10.2 recognizes the trade-distorting potential of export credit support and is thus consistent with the anti-circumvention objective.

Fourth, the Panel and Appellate Body also addressed how the negotiating history confirmed their reading, even though both considered it redundant to resort to this supplementary means of interpretation.[2434] The fact that this was seen as redundant is surprising, not only in light of the ambiguity left by the general rules of interpretation but also because the Appellate Body

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[2426] Appellate Body Report, *US – Upland Cotton*, paras 609-610.
[2427] Appellate Body Report, *US – Upland Cotton*, para 611 (emphasis added).
[2428] Appellate Body Report, *US – Upland Cotton*, paras 632-633 (emphasis added).
[2429] Appellate Body Report, *US – Upland Cotton*, para 633.
[2430] Emphasis added.
[2431] Appellate Body Report, *US – Upland Cotton*, para 615.
[2432] Appellate Body Report, *US – Upland Cotton*, para 616.
[2433] Appellate Body Report, *US – Upland Cotton*, para 617 (emphasis in the original). At the time of the original *US – Cotton* case, the peace clause was still applicable. Today, the argument might be advanced that subsidized export credit support could also be actionable under the SCM Agreement (see below) and would, therefore, not be 'not disciplined *at all*' if Article 10.1 would have been considered inapplicable. Arguably, this should have been anticipated by the Appellate Body (and claimed by the US).
[2434] Appellate Body Report, *US – Upland Cotton*, above n 1739, para 623.

seemed to rely on the general rules of interpretation to sort out the drafters' intention.[2435] If revealing their intention is deemed essential, the preparatory work seems relevant *par excellence*.[2436] In which direction does this preparatory work on Article 10.2 point?

It undeniably shows that export credit support was explicitly on the negotiating table.[2437] Three relevant phases in the drafting process could be distinguished, in which each devoted a separate paragraph to export credit support under the general anti-circumvention article. First, a draft for discussion was circulated whereby '[f]or the purposes of this Article, whether [export credit support] constitute[s] export subsidies shall be determined on the basis of paragraphs (j) and (k) of Annex 1 to the [SCM Agreement]' (phase 1).[2438] Subsequently, this paragraph was omitted in the Dunkel Draft and a new paragraph was inserted: 'Participants undertake not to provide export credits, export credit guarantees or insurance programmes otherwise than in conformity with internationally agreed disciplines' (phase 2).[2439] This was in turn replaced by the current Article 10.2 whereby Members agreed to work toward the development of internationally agreed disciplines and, after agreement, to comply therewith (phase 3). In the reading advocated by the US and the dissenting Appellate Body Member, a shift emerged from an initial proposal of disciplining export credit support by reference to the Illustrative List (phase 1) to a final agreement making such support only subject to future negotiations (phase 3).[2440] However, the Panel read the omission of the provision referring to

[2435] Appellate Body Report, *US – Upland Cotton*, paras 608, 609, 612, 617.

[2436] From a systemic point of view, one might argue that sorting out drafters' intention should not be the purpose of the general rules of interpretation.

[2437] In July 1990, the *DeZeeuw Text* envisaged 'concurrent negotiations to govern the use of export assistance, including "disciplines on export credits"'. Next, the Chairman requested in a *Note on Options in the Agriculture Negotiations* of June 1991, 'decisions by the principals on whether subsidized export credits and related practices ... would be subject to reduction commitments unless they meet appropriate criteria to be established …'. In August 1991, an *addendum* was circulated by the new Chairman Dunkel which set out an Illustrative List of Export Subsidy Practices, including export credits provided by governments or their agencies on less than fully commercial terms and subsidized export credit guarantees or insurance programmes. Note by the Chairman, *Options in the Agriculture Negotiations, Addendum 10* (MTN.GNG/AG/W/1/Add.10, 2 August 1991).

[2438] *Draft Text on Agriculture* (unavailable in GATT archive). Panel Report, *US – Upland Cotton*, para 7.937.

[2439] *Draft Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations* (*Dunkel Draft*) (MTN.TNC/W/FA, 20 December 1991).

[2440] Yet, the US arguments on the correct reading of these drafts were no example of clarity. Its position before the Panel seemed that the reference to the Illustrative List was transposed in indirect terms in phase 2 (under the concept of 'internationally agreed disciplines') but dropped in phase 3. However, it seems unlikely that 'internationally agreed disciplines' include those elaborated in the Illustrative List. First, as Brazil also argued, drafters would arguably have been more specific if they aimed at referring to the Illustrative List. Second, the Illustrative List is simply not 'an internationally agreed discipline' on export credit support for *agricultural* products but, at most, would be relied upon to reveal whether or not such support is subsidized. Hence, the US argument that the reference to the Illustrative List was expressly dropped and replaced during the drafting process would be more plausible if this is situated between phase 1 and 2 (instead of between phase 2 and 3). Indeed, the change from phase 2 to 3 seemed to reflect recognition among drafters that no internationally agreed disciplines were in place at that time. Apparently, the US seems to have altered its position along these lines on appeal. See also J. A. McMahon, *The WTO Agreement on Agriculture – A Commentary* (Oxford: Oxford University Press, the Illustrative List (shift from phase 1 to 2) as reflecting a decision that this paragraph was considered 'mere surplusage' because export credit support was within the scope of disciplines on export subsidies according to the terms of the Agreement.[2441] Although the negotiating history does not offer a clear-cut answer, at least two arguments cast doubt on the accuracy of the Panel's reading. First, contrary to the Panel's suggestion, the negotiating history reveals that it was not evident that the standard for export credit support established under the Illustrative List could be transposed to the context of the Agreement on Agriculture.[2442] Second, the provision referring to the Illustrative List was not merely omitted but was, in the *same* draft, also *replaced* by another provision dealing explicitly with export credit support.[2443] This is given no meaning at all in the Panel's interpretation but would just be the result of coincidence. Without much underpinning, the Appellate Body read the drafting history as revealing that negotiators struggled with this issue and suggesting 'that the disagreement between the negotiators related to which kinds of specific disciplines were to apply to such measures' and not whether such disciplines had to be put in place.[2444]

Other arguments advanced by the US further call into question whether the drafters meant to discipline export credit support under Article 10.1 of the Agreement on Agriculture. The US advocated that it should be given meaning that Members explicitly chose not to include export credit support under the listed items of export subsidies subject to reduction commitments (Article 9.1).[2445] But the Appellate Body explained that '(o)ne reason, for instance, may be that they considered that their (export credit support) programmes did not include a subsidy component, so that there was no need to subject them to export subsidy reduction commitments'.[2446] Yet, this explanation lacks convincing since, as the Appellate Body itself had observed, Members were well aware of the potential trade-distorting impact of subsidized export credit support offered by their trading partners (in particular by the US).[2447] Finally, the US also indicated that, if it would have known that export credit support

2006), 333 pp., at 95; Olsen, above n 2164, at 78; Panel Report, *US – Upland Cotton*, WT/DS267/R/Add.1, Part 3, at D-17 (para 32) and D-31 (footnote 56); United States, *Appellant's Submission* (28 October 2004), paras 374-377.

[2441] Panel Report, *US – Upland Cotton*, para 7.940.

[2442] In previous texts, different standards were elaborated (e.g., addendum circulated by Dunkel (above n 2437)).

[2443] The Panel's reasoning would be more plausible if the references to both the Illustrative List as well as to internationally agreed disciplines would have been stated in the same draft. The dissenting Appellate Body Member (para 636) seemed to attach some weight to the fact that the former was deleted in the draft in which the latter was inserted.

[2444] Appellate Body Report, *US – Upland Cotton*, para 623.

[2445] Brazil objected that Chairman Dunkel's draft (see above n 2437) also included other items in its list, such as tax concessions on exports, which were also not carried over under Article 9.1 but which are, nonetheless, subject to the disciplines under Article 10.1

[2446] Appellate Body Report, *US – Upland Cotton*, para 625

[2447] This recognition precisely underpins the Appellate Body's reading that it was no option for drafters to not make export credit support subject to any discipline at all. Appellate Body Report, *US – Upland Cotton*, para 623.

for agricultural products was indirectly made subject to reduction commitments (through Article 10.1), its base period export subsidy quantity (from which reduction commitments were calculated) would have been much larger.[2448] This indeed seems to show that the US, by far the largest provider of such support, was not aware that such support was already disciplined. Whereas the Appellate Body seems to have neglected this argument, the Panel found that it could not accept the opinion of 'one Member' as representing a shared interpretation among Members.[2449] In this respect, the US also argued that export credit support was not subject to the notification requirements[2450] but the Appellate Body simply observed that 'whether WTO Members with export credit guarantee programmes have reported them in their export subsidy notifications is not determinative (…)'.[2451] Although low legal value should indeed be attached to the notification requirements, they might nonetheless be useful to reveal drafters' intentions.

To summarise, the Panel and Appellate Body found that export credit support was not by virtue of Article 10.2 exempted from Article 10.1. The Appellate Body's main concern seemed to have been that deciding otherwise would mean that export credit support was currently not subject to any discipline *at all*, which could not have been the intention of the drafters. An undiscussed element in favour of this interpretation was that the US also formally agreed during the Uruguay Round that export credit support should be disciplined.[2452] Nonetheless, several arguments also cast doubt on whether the Appellate Body correctly revealed the drafters' intention. First of all, the negotiating record shows that the option to discipline export credit support by reference to the Illustrative List was tabled but replaced by another explicit provision only mandating future negotiations. Moreover, the US as prime provider of such support was certainly not aware that its export credit support was subject to the anti-circumvention provision along the lines interpreted by the Appellate Body. The absence of a reference in the notification requirements to export credit support indicates that other Members seemed to share this interpretation. Last but not least, as

[2448] Panel Report, *US – Upland Cotton*, para 7.941; United States, *Appellant's Submission*, above n 2440, para 385.
[2449] Panel Report, *US – Upland Cotton*, para 7.942.
[2450] United States, *Appellant's Submission*, above n 2440, para 348.
[2451] The Appellate Body observed disagreement on whether export credit support was subject to the notification requirements, but failed to mention which view was correct. It seems that the US position, which was adopted by third-party Canada as well, was correct. The table on notifications refers to (i) 'subsidized exports' and (ii) food aid, and a supporting table specifies six listed types of export subsidies. So, while food aid is explicitly referred to, no reference is made to (subsidized) export credit support. Brazil's argument that subsidized export credit support should, nonetheless, have been notified as 'subsidized exports' seems not plausible, all the more because no Member notified these and because the lack thereof was not contested. Appellate Body Report, *US – Upland Cotton*, paras 220, 625. This also seemed the position of the WTO Secretariat. See Background Paper by the Secretariat, above n 2162, para 41.
[2452] See above n 2062.

explained in more detail below, the Appellate Body's interpretation implies that export credit support for agricultural products is even subject to stricter disciplines than listed types of export subsidies are. It seems implausible that drafters had such an outcome in mind.

Obviously, the dismissal that Article 10.2 exempts export credit support from the scope of Article 10.1 does not mean that export credit support 'will necessarily constitute export subsidies for purposes of the *Agreement on Agriculture*'. Indeed, such support is 'subject to the export subsidy disciplines in the *Agreement on Agriculture* only to the extent that (it includes) an export subsidy component'.[2453] The question addressed in the following section is under what conditions export credit support would meet the definitional elements of an 'export subsidy' in the meaning of Article 10.1.

5.1.1.2. When is export credit support considered an export subsidy in the meaning of Article 10.1 of the Agreement on Agriculture?

Most export credit support for agricultural products takes the form of export credit guarantees or insurance. Such pure cover support was also challenged in the *US – Upland Cotton* dispute. Whereas in the original procedure several different export credit guarantee programmes were challenged by Brazil[2454], the compliance Panel had to review the operation of the one programme left over, namely the GSM 102 programme. This programme guarantees the repayment of credits that do not exceed 3 years.

How should it be determined whether such export credit support for agricultural products is extended at subsidized terms? As accurately summarized and approved by the Appellate Body, given 'the Agreement on Agriculture does not contain a comprehensive definition of the term "export subsidy", the Panel would refer to the SCM Agreement for *contextual guidance* (…) (i)n particular, the Panel said it would *determine* whether GSM 102 guarantees are "export subsidies" by applying the standard set out in item (j) of the Illustrative List'.[2455] Indeed, the Panel in the compliance procedure, in line with the original Panel, formally relied on item (j) as contextual support only, but *de facto* determined the export subsidy qualification on this basis.[2456] Observing no disagreement among parties that an export credit guarantee programme meeting the elements of item (j) is a *per se* export subsidy, the Panel first applied this standard.[2457] Only if the item (j) test would not be met, 'a further contextual

[2453] Appellate Body Report, *US – Upland Cotton*, para 626.
[2454] See also above n 2108.
[2455] Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 260 (emphasis added).
[2456] This seems to be criticized by Benitah. M. Benitah, 'US Agricultural Export Credits after the WTO Cotton Ruling: The Law of Unintended Consequences', 6:2 *The Estey Centre Journal of International Law and Trade Policy* (2005), 107-114, at 111-112; McMahon, above n 2440, at 145.
[2457] Panel Report, *US – Upland Cotton*, para 7.763; Appellate Body Report, *US – Upland Cotton*, para 647.

examination of the definitional elements contained in Articles 1 and 3 of the SCM Agreement' would be undertaken.[2458] Note that if official financing support to agricultural products would be challenged, complainants could likewise rely on item (k) of the Illustrative List for the examination of the 'export subsidy' element under Article 10.1 of the Agreement on Agriculture.

5.1.1.2.1. Export subsidies as defined by item (j) of the Illustrative List

As introduced above, item (j) considers pure cover support as an export subsidy if offered 'at premium rates which are inadequate to cover the long-term operating costs and losses of the (programme)'. A 'programme-wide analysis'[2459] is called for, which compares the level of premiums with the overall long-term costs of the programme to the government. Passing this cost-to-government test only requires 'a finding on whether the premiums are insufficient (…) and not a finding of the precise difference between premiums and long-term operating costs and losses'.[2460] This should be primarily demonstrated on the basis of quantitative evidence but could be supplemented with non-quantitative evidence.

First, to the extent that relevant data are available, *a quantitative evaluation* of the financial performance of a programme should be undertaken revealing 'the difference, if any, between the revenues derived from the premiums charged under the programme and its long-term operating costs and losses'.[2461] To this end, 'both retrospective data relating to a programme's historical performance and projections of its future performance' could be advanced.[2462] Whereas the compliance Panel in *US – Upland Cotton* found support in the quantitative data that the revised programme still operated at a loss, the Appellate Body observed conflicting data on whether the programme was making a loss or not.[2463] Apparently left unnoticed by

[2458] Panel Report, *US – Upland Cotton*, above n 1738, para 7.803.
[2459] Panel Report, *US – Upland Cotton*, para 7.763.
[2460] Appellate Body Report, *US – Upland Cotton*, above n 1739, paras 666-667.
[2461] Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 278.
[2462] Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 278. The original Panel agreed with the parties that the 1992-2002 period was adequately 'long-term', but also indicated that older data and future projections could be relevant. On the compliance level, historical data from the 1992-2006 period were considered together with projections for 2006-2008. Generally speaking, 'long-term' refers to 'a period of sufficient duration as to ensure an objective examination which allows a thorough appraisal of the programme and which avoids attributing overdue significance to any unique or atypical experiences (…)'. Panel Report, *US – Upland Cotton*, para 7.832.
[2463] The Panel had found support in the *initial subsidy estimates* for 2006 and 2007 which projected a net cost to the government. However, the Appellate Body firmly criticized the Panel for dismissing the import of the US argument that *re-estimates* data over the 1992-2006 period projected a profit. As re-estimates take into account information on the historical performance (and estimated changes in future cash flows), they might be more reliable than initial estimates. At the same time, the Appellate Body also observed that the Commodity Credit Corporation's (CCC's) Financial Statements estimated liabilities of $220 million with respect to post-1991 outstanding guarantees. Hence, it was confronted with conflicting data, for which none of the parties could give a convincing explanation.

the Panel as well as the Appellate Body in the compliance procedure, the focus under item (j) should be on the adequacy of *actual* premiums charged. Data on past performance should, therefore, be interpreted with caution as the fee structure under the challenged programme might have changed over time.[2464] Indeed, the relevant question in the compliance procedure was whether the *revised* fee structure under the GSM 102 programme was adequate to cover long-term operating costs and losses.[2465]

Supplementary to this quantitative analysis or in the absence of financial data, *non-quantitative evidence* may be relevant. First, the Appellate Body concurred with the Panel that this could include a comparison between the premiums under the programme and the minimum premium rates (MPRs) as set out in the OECD Arrangement, even though agricultural export credit support is not disciplined by the OECD Arrangement.[2466] In particular, the magnitude of the difference (and not just any difference) between the premiums charged under the GSM-102 programme and MPRs provided an indication that premiums were set on a level inadequate to cover long-term costs.[2467] Second, elements of the 'structure, operation and design' of the revised GSM-102 programme suggested that it operated at a loss. In particular, the Panel found that the structure and design of the revised GSM-102 did not adequately ensure that GSM-102 fees were risk-based, because foreign obligor risk was not reflected in the fees[2468] and the operation of the 1% fee cap prevented adjustment of fees to increased levels of risk (scaling).[2469][2470] Although the Appellate Body

[2464] On the one hand, historical data showing an overall profit are relevant insofar the new fee structure is more stringent than before. Indeed, this *a fortiori*-reasoning seems to be made by the Appellate Body (see Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 299, emphasis added). On the other hand, historical data showing an overall loss is not *per se* an indication of the inadequacy of *actual* premiums if the fee structure has been strengthened over time. Although not explicitly recognized by the Appellate Body, these data *an sich* (e.g., CCC's audited Financial Statements) should have been considered relevant only because it questioned the accuracy of re-estimates data. Of course, projections for the future incorporating the new fee structure (i.e., estimates for 2006 and 2007) are clearly relevant.

[2465] The compliance Panel (para 14.79) and Appellate Body (para 321) focused on this particular question but did not explicitly relate their discussion on quantitative data to this element (except for the Appellate Body as elaborated above n 2464).

[2466] Yet, MPRs do not provide a legally binding benchmark under item (j) as this item, contrary to paragraph 2 of item (k), does not refer to the OECD Arrangement (see above).

[2467] Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, paras 302-306; Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, paras 14.94 – 14.103.

[2468] The Panel agreed with Brazil that foreign obligor risk should not only be reflected via exposure limits (as was the case under the revised GSM-102) but also through fees. Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, paras 14.113 – 14.115. It might be relevant to recall that the MPRs under the OECD Arrangement do not take into consideration foreign buyer/borrower risks but only country risks.

[2469] As an indication, due to this fee cap, the revised GSM-102 fees increased much slower in response to increased risk than the rate of increase of fees charged under Ex-Im programmes. Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 312.

[2470] Another qualitative element considered relevant by the Panel was that the CCC had access to funds from the US Treasury and benefited from the full faith and credit of the US government. The Appellate Body agreed that this could be a factor but correctly emphasized that it is not a significant one for assessing the profitability of the programme under item (j) (Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 319). Indeed, this reveals *as such* nothing about the adequacy of the premiums, but only makes it possible that a programme keeps operating at a loss.

had found that the quantitative data gave rise to opposite conclusions, this non-quantitative evidence provided a 'sufficient evidentiary basis for the conclusion that it is more likely than not that the revised GSM 102 programme operates at a loss'.[2471] As a result, the Appellate Body agreed with the compliance Panel's conclusion that the revised GSM programme was still an 'export subsidy' in the meaning of item (j) and therefore also in the meaning of Article 10.1 of the Agreement on Agriculture.

5.1.1.2.2. Export subsidies as defined by Article 1 juncto 3 of the SCM Agreement

Brazil claimed that the US export credit programme was not only an 'export subsidy' under Article 10.1 in light of the standard set in item (j) but also in the meaning of Article 1 *juncto* 3 of the SCM Agreement, in which the benefit-to-recipient element of Article 1.1(b) of the SCM Agreement forms the crux of the analysis.[2472] As explained above challenging an export credit guarantee *programme* under Article 1 *juncto* 3 of the SCM Agreement seems more difficult in light of the mandatory/discretionary distinction adopted by most panels. But Brazil had a good reason for pursuing this supplementary claim.[2473] Because of the different benchmarks, 'a measure that no longer constitutes an export subsidy under item (j) may still constitute an export subsidy under Articles 1.1 and 3.1(a)'.[2474] Indeed, a programme that runs break-even (item (j)) could still offer guarantees on terms not available on the commercial market or generate export credits at below market terms not compensated by the level of the fee (Article 1 *juncto* 14 of the SCM Agreement).[2475] Yet, the Panel, as endorsed by the Appellate Body, exercised judicial economy on Brazil's 'argument' under Article 1 *juncto* 3 since it already found a violation of item (j).[2476] As Brazil had rightly feared, the US held before the compliance Panel that it implemented the Dispute Settlement Body's (DSB) recommendations by bringing its pure cover programme into accordance with the cost-to-government standard in item (j).[2477] Again, the compliance Panel exercised judicial economy on Brazil's claim under Articles 1 and 3 of the SCM Agreement because the revised pure cover support programme was still found to be inconsistent with item (j).[2478]

2471 Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 321.
2472 See above Part III, Chapter 4, Section 4.2.
2473 In fact, Brazil's first-order argument was based on the Article 1 *juncto* Article 3 analysis.
2474 Appellate Body Report, *US – Upland Cotton*, para 726. Brazil also requested the Panel to make such findings, in case the Appellate Body would disagree with its findings under item (j). Panel Report, *US – Upland Cotton*, para 6.31.
2475 See above n 2472.
2476 Panel Report, *US – Upland Cotton*, paras 6.31, 7.803; Appellate Body Report,
2477 Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, Annex A-2 (para 3). The 2009 report of the Ex-Im Bank to US Congress also referred to the mandate of 'WTO rulings to operate at break-even over the long term'. See Export-Import Bank of the United States, above n 2045, at 13.
2478 Brazil had formulated its first-order claim under Article 1 *juncto* 3 of the SCM Agreement. Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, paras 14.49-14.53.

This exercise of judicial economy fails to acknowledge that the subsidy determination under both options (benefit-to-recipient versus cost-to-government) could give rise to different implementation standards or, at least, would give different guidance on how to implement the DSB's recommendations.[2479] After all, the question was left open as to a correct understanding of the obligation to 'withdraw the *subsidy* without delay' if the subsidy element is only demonstrated on the basis of the cost-to-government standard under item (j).[2480] Ought the US implement the DSB's recommendations if it ensures that its revised programme no longer runs at a cost to the government, even though it might still be beneficial *as such* or *as applied* under Article 1 of the SCM Agreement? Significantly, the Arbitrator decided that this would not be considered full compliance. Making its export credit support programme consistent with item (j) does 'not necessarily ensure full withdrawal' as it might still confer a benefit on the basis of the standard set forth in Article 14(c) of the SCM Agreement.[2481] Thus, the Arbitrator held the view that the standard of full compliance is only fulfilled if no benefit-to-recipient is offered, even if the panels' analyses only focused on item (j) and thus lacked a finding that the more demanding benefit-to-recipient standard was also met.[2482] Accordingly, a subsidy determination under the cost-to-government approach does not give rise to a different implementation standard, even though the implementing country might have difficulties in figuring out how it should exactly ensure that no benefit to the recipient is offered without a determination thereof.

It should be highlighted that the Panel would arguably have looked at Article 1 *juncto* Article 3 of the SCM Agreement for contextual support in case the US export credit programme would *not* have been an 'export subsidy' in the meaning of item (j). This seems to be implied in the Panel's statement that if the item (j) test would not be met, it would be willing to proceed 'to a further contextual examination of the definitional elements contained in Articles 1 and 3 of the SCM Agreement'.[2483] More fundamentally, it was explained that panels have systematically (and correctly) rejected item (j) could be used *a contrario* and thus could be

[2479] Indeed, as Brazil argued, the Panel's failure "to examine Brazil's claim ... leaves open a dispute and creates uncertainty concerning the scope of the United States' obligations, and the consistency of its existing measures with those obligations'. Appellate Body Report, *US – Upland Cotton*, para 727.

[2480] The compliance Panel did not clarify whether the US would have implemented the original DSB's recommendations (based on the item (j) analysis) if the standard of item (j) would have been met under the revised programme, even though the programme or some individual transactions would still confer a benefit.

[2481] In the words of the Arbitrator:

> 'the mere fact that the GSM 102 is rendered consistent with item (j) does not exclude that the programme might nevertheless continue to confer a "benefit" on the basis of the standard set forth in Article 14(c). (…) Brazil would be entitled to continue to apply countermeasures until the full benefit of the GSM 102 programme has been withdrawn (…)'.

Decision by the Arbitrator, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, para 4.162.

[2482] Recall that the US objected that the benefit-to-recipient standard would be met.

[2483] Panel Report, *US – Upland Cotton*, para 7.803.

used to demonstrate that export credit support is not an 'export subsidy' under the SCM Agreement. Hence, the US call for such an *a contrario* reading of item (j) articulated before the Panel in *US – Upland Cotton* would probably not have been accepted.[2484] But recall that the Appellate Body has not yet revealed whether it would agree with this interpretation.[2485]

To summarize, the panel and Appellate Body in *US – Upland Cotton* have found that, despite the presence of Article 10.2, export credit support is also covered under the first paragraph of Article 10 if it is offered at subsidized terms. This is determined by reference to the Illustrative List (items (j) or (k)) or Article 1 *juncto* Article 3 of the SCM Agreement.

5.1.2. Disciplines: Circumvention or threat of circumvention

Export credit support at subsidized terms is only inconsistent with Article 10.1 if 'applied in a manner which results in, or which threatens to lead to, circumvention of export subsidy commitments'. In line with the Appellate Body's interpretation in *US – FSC*, the panels in *US – Upland Cotton* reasoned that circumvention would exist when subsidized export credit support by the US would result in export subsidies to scheduled products *above* its reduction commitment levels or to unscheduled products *tout court*. Conversely, no circumvention would be present when such support would not result in export subsidies to scheduled products above reduction commitment levels.[2486] Indeed, in the words of the compliance Panel:

> For unscheduled products, "circumvention" of the United States' export subsidy commitments will occur if *any* export subsidies (in the form of GSM 102 export credit guarantees) are provided in respect of *any* quantity of exports of the product in question. For scheduled products, "circumvention" will occur if the United States provides export subsidies to volumes of exports of the product at issue *in excess* of its "quantity" reduction commitments or of its "budgetary outlay".[2487]

[2484] Panel Report, *US – Upland Cotton*, para 7.772. Footnote 5 of the SCM Agreement stipulates that '(m)easures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement'.

[2485] Appellate Body Report, *US – Upland Cotton*, para 731; Appellate Body Report, *Brazil – Aircraft (Article 21.5 – Canada))*, para 80. The latest draft circulating in the Negotiation Group on Rules would inscribe the reading adopted by the panels on the *a contrario* reading in a new footnote 6 of the SCM Agreement (replacing the current footnote 5). Negotiating Group on Rules, *New Draft Consolidated Chair Texts of the AD and SCM Agreements* (TN/RL/W/236, 19 December 2008).

[2486] This could also be revealed from the Appellate Body's general statement in *Canada – Dairy (Article 21.5 – New Zealand and US II)* that '(p)ursuant to Article 3 of the *Agreement on Agriculture*, a Member is *entitled* to grant *export subsidies* within the limits of the reduction commitment specified in its Schedule' (Appellate Body Report, *Canada – Dairy (Article 21.5 – New Zealand and US II),* para 70).

[2487] Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 14.137. As stated in a positive way by the original Panel in *US – Upland Cotton*: in general terms, these export subsidy provisions (i.e., Articles 9 and 10) 'permit a limited number of Members to use *export subsidies, as defined in that Agreement*, within the limits of the budgetary outlay and/or quantitative commitments (…) and only with respect to the agricultural products described therein'. Panel Report, *US – Upland Cotton*, para 7.664 (emphasis added). The Panel continued (para 7.665) as regards to non-listed export subsidies that such

As a result, subsidized export credit support for unscheduled products (such as upland cotton) as well as for three scheduled products in excess of the US quantity commitments (i.e. rice, pig meat, poultry meat) were deemed inconsistent with the anti-circumvention obligation of Article 10.1 of the Agreement on Agriculture in the compliance procedure.[2488] To arrive at this conclusion for scheduled products, Brazil had successfully demonstrated that the quantity of exports of these products benefiting from *GSM-102 export credit guarantees* were clearly above the respective US quantity commitments. In fact, Brazil's claim would have been accepted even if it had only demonstrated that the quantity of exports of these products benefiting from *any type of export subsidy programme* (listed export subsidies as well as non-listed ones) was above the respective quantity commitments. Even more, by virtue of the special rule on the burden of proof elaborated in Article 10.3 of the Agreement on Agriculture, Brazil could simply have demonstrated that the level of *exports* of the scheduled products were above the respective commitment levels, which would have shifted the burden of proof to the US to demonstrate that the excess levels were not subject to any export subsidy whatsoever (listed or non-listed ones).

In essence, non-listed export subsidies such as subsidized export credit support are thus disciplined similarly under the 'anti-circumvention' standard of Article 10.1 as listed ones are under Article 3.3 *juncto* 9.1 of the Agreement on Agriculture. But even if no such 'actual circumvention' of export subsidy commitments would be found, a violation of Article 10.1 of the Agreement on Agriculture would be present if subsidized export support is applied in a manner which *threatens* such circumvention.[2489] In the original procedure, Brazil had also formulated an additional claim that US export credit support caused such a threat of circumvention. The Appellate Body concurred with the Panel that such an additional claim

'export subsidies *in excess of commitment levels*, in respect of scheduled or non-scheduled products, is *subject to* the anti-circumvention provisions of Article 10.1' (emphasis added). This confirms the Panel's interpretation that no circumvention can be present up to the level of reduction commitment levels. But, by stipulating that excess levels of export subsidies are merely *subject to* the anti-circumvention provision, this statement also conflicts with the Appellate Body's interpretation and its own application of the anti-circumvention standard. For example, the Panel observed that parties agreed that Article 8 Agreement on Agriculture, which elaborates the general obligation on export competition commitments, 'serves to *prohibit* the use of *listed and non-listed* export subsidies in excess of reduction commitment levels in the case of scheduled products and to prohibit the use of export subsidies otherwise than in conformity with reduction commitments and the provisions of the Agreement' (para 7.921, first emphasis added). See also Panel Report, *US – Upland Cotton*, paras 7.875, 7.879-7.881. In the original procedure, the Appellate Body also confirmed its previous interpretation as regards to unscheduled products by stipulating in general terms that '(*e*)*xport subsidies* for both unscheduled agricultural products and industrial products are *completely prohibited* under the Agreement on Agriculture and under the SCM Agreement, respectively' (para 652, emphasis added).

[2488] Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, paras 14.139-14.150. This anti-circumvention analysis was not appealed. See Appellate Body Report, *US – Upland Cotton (Article 21.5 – Brazil)*, paras 269 and 323.

[2489] Appellate Body Report, *US – FSC*, paras 148-154.

has to be examined only for those agricultural products for which the actual circumvention test was not passed, which was the case for scheduled agricultural products within reduction commitments and unscheduled agricultural products not supported under the export credit guarantee programmes.[2490] Yet, as explored in detail in Part II, the Appellate Body disagreed with the Panel on the substance of the 'threat of circumvention' test.[2491] The Panel had rejected Brazil's claim because the operation of the export programmes did not necessarily *require* issuing guarantees to these agricultural products.[2492] The Appellate Body rejected, however, this high threshold to find 'threat of circumvention'. It should not be shown that the export credit programmes generate the *unconditional legal right* to receive such support, but only that they are applied in a manner that would *likely* lead to circumvention of reduction commitments.[2493] To be sure, this test should not be interpreted as widely that it would require WTO Members to take affirmative, precautionary steps to ensure that such circumvention does not occur.[2494] Moreover, this standard is also not met in case it is only demonstrated that exports of the products in question are *eligible* for export credit guarantees and the subsidizing Member has *provided* export credit guarantees to exports of *other* unscheduled products or to exports of scheduled products in excess of its export subsidy reduction commitments. The presence of both elements under the US export credit programmes was indeed insufficient to demonstrate a 'threat of circumvention', particularly because of the lack of evidence of past subsidization of those particular agricultural products under these programmes.[2495] Although the Appellate Body thus widened the scope of 'threat of circumvention', it agreed with the Panel's conclusion that such a threat was not demonstrated.[2496]

In conclusion, the standard of actual anti-circumvention imposed upon subsidized export credit support under Article 10.1 of the Agreement on Agriculture is parallel to the (reduction) commitment standard imposed on listed export subsidies under Article 3.3 *juncto* 9.1 of the Agreement on Agriculture. WTO Members are not allowed to grant '*any subsidy whatsoever to exports* of unscheduled products'[2497] and of scheduled products above their

[2490] Appellate Body Report, *US – Upland Cotton*, paras 715-719; Panel Report, *US – Upland Cotton*, para 7.882 (footnote 1061).
[2491] See above Part II, Chapter 6, Section 6.2.1.2.2.2.2.
[2492] Panel Report, *US – Upland Cotton*, para 7.895.
[2493] Appellate Body Report, *US – Upland Cotton*, paras 704-710.
[2494] Appellate Body Report, *US – Upland Cotton*, paras 707, 713.
[2495] Appellate Body Report, *US – Upland Cotton*, paras 713-714.
[2496] Brazil did not formulate the argument of a 'threat of circumvention' at the compliance level.
[2497] Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, footnote 782 (emphasis added). According to the Panel, this is stipulated under Article 3.3 of the Agreement on Agriculture. However, the text of Article 3.3 only deals with listed types of export subsidies on (un-)scheduled products. The general obligation on listed as well as non-listed types of export subsidies is Article 8 of the Agreement on Agriculture.

reduction commitment level. What is more, non-listed export subsidies like subsidized export credit support are even disciplined more severely as a *likelihood* of such circumvention ('threat of circumvention') suffices to find an inconsistency with Article 10.1 of the Agreement.[2498] As explained in Part II, this conclusion also seems to hold for developing countries, even if they are allowed to offer two types of listed export subsidies by virtue of Article 9.4 of the Agreement on Agriculture. This means that countries having no scheduled agricultural products, such as India and China, could not offer any subsidized export credit support for agricultural products and that a threat thereof would even suffice to find a WTO inconsistency. In case of China, there is no doubt that it could not offer such subsidized export credit support as it explicitly committed at the moment of accession not to maintain or introduce any export subsidy upon agricultural products.[2499] In contrast, countries such as the EC, the US, and Canada are allowed to offer subsidized export credit to agricultural products up to their reduction commitment levels.

Turning back to the *US – Upland Cotton* case, the panels in the original as well as compliance procedure thus found that the US offered subsidized export credit in violation of Article 10.1 of the Agreement on Agriculture. Next to an inconsistency with the Agreement on Agriculture, Brazil also claimed that this export credit support violated Article 3 of the SCM Agreement. This claim is examined in the following section.

5.2. EXPORT CREDIT SUPPORT FOR AGRICULTURAL PRODUCTS UNDER THE SCM AGREEMENT

In *US – Upland Cotton*, Brazil's claim under Article 3.1(a) of the SCM Agreement was confined to export credit support found *inconsistent* with the Agreement on Agriculture. The relevance of such a claim lies in the stricter implementation obligations resulting from a violation of the SCM Agreement's prohibited subsidies provisions. In particular, Article 4.7 of the SCM Agreement mandates the panel to make an additional recommendation to 'withdraw the subsidy without delay' if a prohibited subsidy is found to exist under the SCM Agreement, which will become a recommendation or ruling of the DSB.[2500] Moreover, the level of countermeasures in case of non-implementation might also be higher when based on Article 4.11 of the SCM Agreement. Yet, by shifting to a trade effects approach to calculate 'appropriate countermeasures', the Arbitrator in *US – Upland Cotton* largely neutralized this

[2498] Foreclosing this conclusion might have been the reason why the original Panel read 'threat of circumvention' in a narrow way. This interpretation would be in line with the mandatory/discretionary distinction. See above Part III, Chapter 4, Section 4.1.
[2499] *Report of the Working Party Report on the Accession of China* (WT/ACC/CHN/49), para 241.
[2500] Article 4.7 of the SCM Agreement is a special rule superseding the general rule established in Article 19.1 of the DSU (Article 1.2 of the DSU stipulates the 'lex specialis derogat legi generali' maxim). See Appellate Body Report, *EC – Export Subsidies on Sugar*, paras 329-335.

difference. The only difference seems that arbitrators retain somewhat more leeway to opt for assumptions that are probably overestimating trade effects when confronted with prohibited subsidy violations under the SCM Agreement.[2501]

The Panel in *US – Upland Cotton* considered that agricultural export subsidies *inconsistent* with the Agreement on Agriculture are not exempted from the applicability of Article 3.1(a) of the SCM Agreement.[2502] Next, applying directly the same 'export subsidy' standard upon which it had indirectly relied under the Agreement on Agriculture (i.e., item (j)), the Panel concluded – and the Appellate Body agreed – that *to the extent* US export credit guarantees were inconsistent with the Agreement on Agriculture, they were also inconsistent with Article 3.1(a). Nonetheless, its conclusions and recommendations seemed to be formulated more broadly because the Panel in respect of unscheduled products supported under the programme and 'in respect of one scheduled product (rice)' concluded that the export credit guarantees 'constitute per se export subsidies prohibited by Articles 3.1(a) and 3.2 of the SCM Agreement' which the US has to withdraw without delay.[2503] Hence, was the US also required, by virtue of the application of the SCM Agreement, to withdraw export credit guarantees to the scheduled product (rice) below the level of reduction commitments and thus in conformity with the Agreement on Agriculture? The Appellate Body in *EC – Export Subsidies on Sugar* seemed to have revealed this ambiguity in the *US – Upland Cotton* panel's reasoning when questioning 'whether, in the event the SCM Agreement applies, a panel could make a recommendation to withdraw the subsidy in whole, or whether that recommendation would apply to the subsidy only to the extent that it exceeds the responding Member's commitment levels'.[2504] Parallel to the original Panel, the Panel in the *US – Upland Cotton* compliance procedure decided that 'there is no question' that, to the extent export credit guarantees were still inconsistent with the Agreement on Agriculture, they were inconsistent with the export subsidy prohibition of Article 3.1 of the SCM Agreement.[2505] Apparently taking the Appellate Body's holding in *EC – Export Subsidies on Sugar* into consideration, the Panel specified in its conclusion that 'the US also acts inconsistently with Articles 3.1(a) and 3.2 of the SCM Agreement by providing export subsidies to unscheduled products and by providing export subsidies to scheduled products *in excess of the commitments of the US under the Agreement on Agriculture*'.[2506] Hence, the Panel applied

[2501] See above, Part II, Chapter 5, Section 5.1.3.1.1.
[2502] Panel Report, *US – Upland Cotton*, para 7.947. The Panel only cited Article 3.1(a) of the SCM Agreement but also referred to its general discussion on both Agreements' relationship under the part on local content subsides which included a discussion on Article 21.1 Agreement on Agriculture. Appellate Body Report, *US – Upland Cotton*, paras 583-584 (footnote 858), 629-630, 674, 732.
[2503] Panel Report, *US – Upland Cotton*, para 8.1(d)(i) and 8.3(b).
[2504] Appellate Body Report, *EC – Export Subsidies on Sugar*, para 537.
[2505] Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 14.154.
[2506] The Panel continued that '(b)y acting inconsistently with Articles 10.1 and 8 of the Agreement on Agriculture and and Articles 3.1(a) and 3.2 of the SCM Agreement the US has failed (…)"to withdraw

the SCM Agreement to the subsidy only to the extent that it exceeded the US commitment levels and, by logical consequence, also explicitly confined its conclusions under the SCM Agreement to the part of the subsidy inconsistent with the Agreement on Agriculture. As a result, the US only had to withdraw the subsidy to the extent that it was inconsistent with the Agreement on Agriculture (i.e., exceeds its commitment levels).[2507]

Brazil did not formulate the claim that the level of export credit support in *conformity* with the Agreement on Agriculture (i.e., to scheduled products below US commitment level) was also inconsistent with Article 3.1(a) of the SCM Agreement. Therefore, the Panel in the compliance procedure left undecided whether, now that the peace clause had lapsed, 'there may be a violation of Articles 3.1(a) and 3.2 of the SCM Agreement in respect of *all* exports (i.e., even those that conform to the disciplines of the Agreement on Agriculture)'.[2508] Although neither the SCM Agreement nor the case law has offered a decisive answer as of yet, the discussion in Part II has argued why agricultural export subsidies in conformity with the Agreement on Agriculture should still be exempted from the prohibition on export subsidies under the SCM Agreement. At the same time, this discussion advanced solid arguments not to exempt such agricultural export subsidies from potential 'actionable subsidy' claims and CVDs actions. In this reading, subsidized export credit support to agricultural products in conformity with the Agreement on Agriculture would thus only be vulnerable to actionable subsidy and CVDs claims.[2509]

To summarize, case law has clarified that *subsidized export credit support for unscheduled products and for scheduled products above reduction commitments* are inconsistent with Article 10.1 of the Agreement on Agriculture but are also prohibited under Article 3.1 of the SCM Agreement.[2510] As a result, to the extent they are inconsistent with the Agreement on Agriculture, they should be withdrawn without delay pursuant to Article 4.7 of the SCM Agreement. Only those developing countries benefiting from S&D treatment on the prohibition of Article 3.1(a) are exempted from the additional application of Article 3 of the

the subsidy without delay"'. Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, para 15.1(c) (emphasis added).

[2507] The Panel did not explicitly state this conclusion, but it can be inferred from its reasoning as previously quoted in the full text and in footnote 2506. This was also taken into account by the Arbitrator when calculating the appropriate amount of countermeasures. Decision by the Arbitators, *US – Upland Cotton (Article 22.6 – US) (prohibited subsidies)*, para 4.207.

[2508] Panel Report, *US – Upland Cotton (Article 21.5 – Brazil)*, footnote 785.

[2509] This is similar to the treatment of subsidized export credit support for non-agricultural products in conformity with the OECD Arrangement.

[2510] An exception should arguably be made for agricultural export credit support that merely is a 'threat of circumvention'. Without textual reference to such a 'threat' in the applicable SCM Agreement provisions and given the application of the mandatory/discretionary principle, it is far from evident that such a threat of circumvention would also be inconsistent with the SCM Agreement.

SCM Agreement to such agricultural export subsidies.[2511] As these countries do not have scheduled agricultural products, any subsidized agricultural export support is inconsistent with the Agreement on Agriculture but not subject to the stricter implementation standard of the SCM Agreement.[2512] On the other hand, *subsidized export credit support for scheduled products within reduction commitments* seems not prohibited but, nonetheless, actionable and countervailable under the SCM Agreement.

Contrary to the regulatory framework for export credit support to non-agricultural products, WTO Members do thus not compete on a level playing field regarding agricultural export credit support. Indeed, only those 25 WTO Members having scheduled agricultural products are allowed to provide export credit support at *subsidized* terms and this insofar their total level of export subsidies (listed or non-listed types) does not surpass their reduction commitment levels. In contrast, countries having no scheduled products (e.g., India) are not allowed to offer subsidized export credit support at all.

[2511] After all, LDCs and those low-income countries listed in paragraph (b) of Annex VII of the SCM Agreement are exempted from the prohibition on export subsidies pursuant to Article 27.2 of the SCM Agreement.

[2512] Because such support is already inconsistent with the Agreement on Agriculture without having to demonstrate adverse trade effects, the potential additional claim that these subsidies are actionable pursuant to Article 27.7 of the SCM Agreement seems not relevant in practice.

6. EXPORT CREDIT SUPPORT IN LIGHT OF THE GATS

This section examines whether there are disciplines in place on export credit support for services/service providers. Surely, the disciplines of the OECD Arrangement are applicable to this transaction as this agreement explicitly covers export credit support for services. But the analysis under the WTO framework is more complicated. Before focalizing on export credit support disciplines, the general disciplines on subsidization under the GATS have to be introduced.

As the SCM Agreement is an Annex 1A agreement on trade in *goods*, this Agreement only disciplines subsidies affecting trade in goods.[2513] Indeed, measures affecting trade in services are exclusively disciplined under the GATS but, as shortly introduced in Part II, this agreement is rather flexible on subsidization.[2514] Article XV of the GATS is the only provision explicitly dealing with subsidies, but it does not impose any substantive obligation upon WTO Members. Next to the obligation to give 'sympathetic consideration' to requests of other WTO Members adversely affected by subsidization, this provision only stipulates that WTO Members have to launch negotiations to develop disciplines on trade-distorting subsidies. In the course of these negotiations, Brazil has warned that the OECD Arrangement 'had had an unfortunate influence on the negotiations of the (SCM Agreement)', which 'should be avoided in the negotiations of any services disciplines'.[2515] Because negotiations on subsidy disciplines have been far from productive, it seems very unlikely that any specific substantive discipline will emerge if the Doha Round would be concluded.[2516]

Despite the absence of specific disciplines on subsidization, it could be argued that the principles of non-discrimination could impose substantive obligations on subsidization under GATS.[2517] First, pursuant to the Most-Favoured-Nation (MFN) provision, Members are not

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[2513] Marrakesh Agreement Establishing the World Trade Organization, List of Annexes.

[2514] See above Part II, Chapter 1, Section 1.4.

[2515] See Report on the Working Party of GATS Rules, *Report of the Meeting of 10 May 2001* (S/WPGR/M/32, 17 May 2001), para 11.

[2516] Article XV of the GATS. See *Annual Report of the Working Party on GATS Rules to the Council for Trade in Services (2009)* (S/WPGR/19, 2 October 2009, para 5; R. Adlung, 'Negotiations on Safeguards and Subsidies in Services: A Never-ending Story?', 10:2 *Journal of International Economic Law* (2007), 235-265; P. Poretti, 'Waiting for Godot: Subsidy Disciplines in Services Trade', in M. Panizzon, N. Pohl, and P. Sauvé (eds), *The GATS and the Regulation of International Trade in Services* (Cambridge: Cambridge University Press, 2008), 466-488.

[2517] The scope of the GATS encompasses subsidies given that the GATS applies to 'measures by Members affecting trade in services' (Article I:1 of the GATS). See, for example, World Trade Report 2006, above n 2057, at 195; G. Gauthier, E. O'Brien, and S. Spencer, 'Déjà Vu, or New Beginning for Safeguards and Subsidies Rules in Services Trade?', in P. Sauvé & R. Stern, *Gats 2000 – New Directions in Services Trade Liberalization* (Washington DC: The Brookings Institution, 2000), 165-183, at 177; M. Krajewski, 'Public Services and Trade Liberalisation: Mapping the Legal Framework', 6:2 *Journal International Economic Law* (2003), 341-367, 361; Adlung, above n 2516, at 240; Poretti, above n 2516, at 467-470. Matsushita et al disagree and instead opine that subsidies are not covered by the national treatment provision of Article XVII GATS because for the subsidies negotiations (instructed by Article XV GATS) to have a mandate, subsidies must by definition be discriminatory. M. Matsushita, T. J. Schoenbaum and P. C. Mavroidis, *The World Trade Organization – Law, Practice and Policy*, 2nd ed allowed to discriminate among foreign services and service suppliers when offering subsidies.[2518] Second, contrary to the GATT, the obligation of national treatment under the GATS does not explicitly exclude subsidies.[2519] Since the GATS national treatment obligation is dependent on specific commitments, this does not *as such* curtail WTO Members' right to subsidize their service sectors. But if WTO Members make commitments on specific service sectors, they should explicitly reserve their right to subsidize in a discriminatory way.[2520] Otherwise, they might have to provide like treatment to foreign service suppliers with respect to subsidies. The 2001 Scheduling Guidelines also adopt this approach: 'Article XVII applies to subsidies in the same way as it applies to all other measures. (…) Therefore, any subsidy which is a discriminatory measure within the meaning of Article XVII would have to be either scheduled as a limitation on national treatment or brought into conformity with that article'.[2521] In order to grasp the reach of this obligation, two clarifications have to be made. First, as the 2001 Scheduling Guidelines indicate, 'a binding under Article XVII with respect to the granting of a subsidy does not require a Member to offer such a subsidy to a services supplier located in the territory of another Member'.[2522] After all, there is no obligation in the GATS requiring a Member to take measures outside its territorial jurisdiction. Second, it should be recalled that the GATS disciplines trade in services by focusing on four modes of supply. Obviously, the national treatment obligation only applies to subsidies affecting one of these modes of supply, and only insofar such a commitment is undertaken under a particular mode of supply. Adlung observes that, from the perspective of the Scheduling member, the current disciplines on the different modes of supply do not extend to exports, but instead, focus exclusively on the

(Oxford: Oxford University Press, 2006), 889 pp., at 660-661. One might object that the mandate for negotiations on the basis of Article XV GATS remains sufficiently open, given that subsidies are only disciplined by Article XVII insofar Members make specific commitments in this respect. More fundamentally, the argument by Matsushita et al is simply flawed because even if subsidies are not discriminatory, they could well be trade-distorting. Indeed, WTO Members might very well offer subsidies to domestic as well as to foreign service providers established *within* their territory alike (e.g., to attract foreign service suppliers) and thus conform to the national treatment obligation. Yet, this might still be considered as trade-distorting from the perspective of foreign service providers established *outside* the territory of the subsidizing Member (as well as from the perspective of other WTO Members). Indeed, as this discussion will illustrate, the national treatment obligation does not discipline subsidies affecting the competitive relationship between service providers established in different territories.

2518 This applies insofar it affects one of the four modes of supply. The MFN obligation is a general obligation (Article II.1 of the GATS), and thus not dependent on specific commitments. At the end of the Uruguay Round (or at the moment of accession), Members could schedule exceptions to this obligation (Article II.2 of the GATS). See Adlung, above n 2516, at 240 and 260.

2519 Compare Article III:8(b) of the GATT and Article XVII of the GATS.

2520 Some Members indeed made a horizontal reservation to uphold their right to subsidize in a discriminatory manner.

2521 The 2001 Scheduling Guidelines are not binding, but the Appellate Body in *US – Gambling* decided that they could serve as supplementary means of interpretation when interpreting individual Schedules. See Appellate Body Report, *US – Gambling*, para 196.

2522 See *Scheduling Guidelines* (S/L/92, 28 March 2001), para 16.

conditions governing cross-border imports: Mode 1 (cross-border trade): cross border imports; Mode 2 (consumption abroad): consumption of services in the territory of another Member; Mode 3 (commercial presence): services provided by foreign-established suppliers; Mode 4 (presence of natural persons) services provided by foreign natural persons. At the same time, it should be highlighted that measures affecting exportation of services are not excluded under Mode 3 (and Mode 4).[2523] Indeed, once a foreign service supplier is established, the GATS disciplines all measures affecting the supply of services by this supplier. By inference, it seems not limited to measures affecting services provided by foreign service suppliers in the territory of the committing Member. Adlung gives an example of the exemption of foreign-established companies[2524] from an export promotion scheme, which would be incompatible with national treatment under Mode 3.[2525]

In sum, a Member which made an unrestricted national treatment commitment under Mode 3 for a particular service sector is not obliged to offer parallel subsidies to like service suppliers located outside its territory, but like foreign suppliers established within its territory should equally benefit from domestic/export subsidies as domestic service suppliers.[2526] As a result, subsidized export credit support should not be offered at the same terms to foreign service providers outside a Member's territory but should be made available to foreign service providers established domestically if such a commitment in a particular sector is made. In practice, this obligation will be mostly fulfilled as Members will often not have an incentive to discriminate against foreign service suppliers established domestically. For employment or other economic reasons, they would rather offer incentives to foreign service suppliers so as to attract their establishment.[2527] As one of the objectives of export credit support is creating domestic jobs, the eligibility for such support is mostly determined on the basis of the establishment of the service provider. For instance, to be considered 'US content' and thus be eligible for export credit support, the service provider should be established in the US.[2528] In contrast, the service provider does not qualify as 'US content' when the service is supplied by a provider established in the buyer's country (e.g., subsidiary of the US firm).[2529]

Contrary to the SCM Agreement, GATS thus puts no restrictions on export credit support offered to domestically established service providers. Tackling export subsidies for services in the same way as under the SCM Agreement would entail a departure from the import-

[2523] In view of Adlung, reverse flows (e.g., outward foreign investment) are not captured as long as the respective policies have no follow-up effect on imports. Adlung, above n 2516, at 240.
[2524] These are foreign companies that are established locally.
[2525] Adlung, above n 2516, footnote 12.
[2526] Unless it is justified on the basis of an exception (e.g., Article XIV of the GATS), which seems unlikely.
[2527] Adlung, above n 2516, at 248.
[2528] The service itself could be supplied from US territory or in the buyer's country.
[2529] It can only be supported up to 30% as 'local cost' or, alternatively, as 'ancillary service fees' (see above n 2395, 2396).

oriented scope of current GATS disciplines. Given that export credit support for service providers is becoming more and more prominent, this lack of disciplines might be worrisome. On the other hand, this concern should be tempered as OECD Participants have to respect the disciplines of the OECD Arrangement.

In general, export credit support by G-7 ECAs for services takes two forms. First, a marginal share is offered for 'stand-alone services' (i.e., services that are not part of a capital goods transaction) and is short-term in nature (e.g., consulting services, computer software systems). Second, the bulk of this support is extended to medium- and long-term services that are associated with capital goods exports and/or large projects ('associated services'), such as telecommunication or energy (e.g., mining, oil, gas) services.[2530] Because 'stand-alone services' only affect trade in services, they are exclusively disciplined under the GATS as elaborated above. At most, Members having made a full national treatment commitment under Mode 3 in a certain sector will have to offer such support at similar terms to domestic and foreign service providers established within their territory, but the terms of such support are not disciplined at all. This equally applies to OECD Participants because the OECD Arrangement leaves short-term export credit support untouched. In contrast, export credit support for 'associated services' will be disciplined under the SCM Agreement insofar it affects trade in goods.

Take the example of a US Ex-Im Bank long-term loan guarantee to a US engineering/construction company that secures a contract with the Ghanaian government for the construction of oil-storage tanks and pipelines.[2531] The loan guarantee will cover, *inter alia*, the export sale and related local project costs. The company's vice president observed that 'if Ex-Im bank hadn't helped us win this contract, it would have gone to a Chinese competitor'. Arguably, this support for the construction of infrastructure would generally be considered as export credit support for services (e.g., in Ex-Im Bank statistics). But if China would challenge this export credit support before the WTO, disciplines under the SCM Agreement would arguably be relevant. Indeed, the Appellate Body has confirmed in *EC – Bananas III* that the GATT 1994 and the GATS may overlap in application of measures that involve a service relating to a particular good or a service supplied in conjunction with a particular good. Those aspects of the measure affecting trade in goods are scrutinized under

[2530] Over the period 2006-2008, the US Ex-Im Bank's support for both types of services more than doubled. 85% of all support given to associated services by the US Ex-Im Bank was for mining, oil and gas, and engineering and consulting services. See Export-Import Bank of the United States, above n 2045, at 45-46.

[2531] See Export-Import Bank of the United States, 'Annual Report 2007, Featured Companies, American Tank & Vessl Inc.'. Available at:
http://www.exim.gov/about/reports/ar/ar2007/images/AT&V.pdf.

the GATT, whereas the GATS applies to aspects affecting the supply of the service.[2532] The same line of reasoning seems to apply for the relationship between the SCM Agreement and the GATS. Export credit support to the US construction firm is the kind of measure that affects trade in services as well as trade in goods. First, if such export credit support is only available to US construction companies and not to foreign construction companies established in the US, the measure would affect the establishment of foreign construction companies in the US. In that case, the US might have violated Article XVII of the GATS if it had made a national treatment commitment under Mode 3 for construction services without any restriction.[2533] This shows that the GATS, contrary to the Agreements on trade in goods, gives investment protection as well.[2534] Second, it is clear that the contract which is guaranteed affects not only trade in services but also trade in (capital) goods. Indeed, the exportation of oil-storage tanks and pipelines (trade in goods) as well as the installation in Ghana (trade in services) is guaranteed. As a result, the obligations under the SCM Agreement would nonetheless apply to the part of the transaction affecting trade in goods. In sum, export credit support for 'associated services' is not exempted from scrutiny under the SCM Agreement insofar it affects trade in goods. Medium- and long-term support for 'associated services' offered by OECD Participants is also disciplined under the OECD Arrangement.

Finally, observe that the GATS might also discipline other aspects of the export credit support transaction, namely those affecting the *providers* of export credit (support) services. First, private financial institutions often operate as intermediary in the export credit support transaction. For example, in *Brazil – Aircraft*, interest rate support (PROEX interest rate equalization payments) was granted to private banks which covered, at most, the difference between the interest charges contracted with the foreign buyer and the cost to the financing party of raising the required funds. As the Panel in the second compliance proceedings observed, these payments could be considered subsidies in respect of financial services.[2535] The same conclusion holds for export credit guarantees or refinancing given by an ECA to private financial institutions to support export credits extended to foreign buyers. Private financial institutions clearly benefit from such an intermediary role because it improves the loan conditions they can offer to potential borrowers. Could foreign financial institutions

[2532] Whether such measures are scrutinized 'under the GATT 1994 or the GATS, or both, is a matter that can only be determined on a case-by-case basis'. Appellate Body Report, *EC – Bananas III*, para. 221.
[2533] This is similar to the disciplines on 'stand-alone services'.
[2534] Note that if export credit support would instead have been given to non-service sectors such as the car industry, foreign established producers could not make a similar claim under the GATT if they would have been excluded from export credit support. Often, instruments outside the WTO (e.g., Bilateral Investment Treaties) oblige countries to give national treatment to foreign owned companies.
[2535] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, footnotes 41 and 68.

claim that the national treatment provision is violated in case they are excluded from acting as intermediary? If the Member providing such export credit support made a full financial service commitment under Mode 3, a violation of the national treatment obligation would be present in case the foreign financial institution is established in the territory of the Member in question, unless it could be demonstrated that foreign and domestic service suppliers are not 'like'.[2536] However, other foreign financial institutions could perfectly be excluded.[2537] Second, could the position of the ECA itself, which provides a service in the form of export credit support, be challenged under the GATS as well? After all, private financial institutions might face unfair competition from ECAs in the trade finance market. This is one of the rationales for disciplining export credit support by ECAs in order for them not to crowd out or inhibit the private sector by offering support at better-than-market terms. Could foreign financial institutions established in another Member claim that this Member is violating its specific commitments because of the position of an ECA?[2538] Bear in mind that in some countries an ECA is not a governmental or publicly owned agency but a private institution mandated by the government to offer officially supported export credits. Yet, the Annex on Financial Services might exclude services provided by all different types of ECAs from the scope of the GATS as they might be considered 'public entities'.[2539] Moreover, even if the service supplied by ECAs would be covered, any substantive obligation would be dependent upon a specific commitment on national treatment (under Mode 3). Even in case such a commitment has been made, the 'likeness'-test and 'less favourable treatment'-test of Article

[2536] The exceptions under the GATS as well as the prudential carve out in the Annex on Financial Services (para 2(a)) could still be invoked.

[2537] Note that the PROEX interest equalization payments in *Brazil – Aircraft* were not restricted to Brazilian banks but open to all financial institutions. Furthermore, no claims were made under the GATS. See Panel Report, *Brazil – Aircraft (Article 21.5 – Canada II)*, para 7.34.

[2538] The relevant discipline would be Article VIII:1 GATS. Members have to ensure that monopolies and exclusive service suppliers do not act inconsistently with the MFN and specific commitments obligations.

[2539] Excluded from the scope of the GATS are 'services supplied in the exercise of governmental authority' (Article 1.3(c) of the GATS). The Annex on Financial Services specifies that this covers, *inter alia*, 'other activities conducted by a public entity for the account or with the guarantee or using the financial resources of the Government' (para 1(b)). A public entity is further defined as:

> '(i) a government, a central bank or a monetary authority, of a Member, or an entity owned or controlled by a Member, that is principally engaged in carrying out governmental functions or activities for governmental purposes, *not including an entity principally engaged in supplying financial services on commercial terms*; or
>
> (ii) a private entity, *performing functions normally performed by a central bank or monetary authority,* when exercising those functions'. (para 5(c), emphasis added)

Here, two elements could undermine the conclusion that ECAs are public entities and thus excluded from the scope of GATS. First, a 'public entity' could be a private entity but only if it performs functions which are normally performed by a central bank or monetary authority. Given that ECAs arguably do not perform such functions, a private entity offering export credit support would not be considered a public entity and would thus be covered under the GATS. Second, if ECAs would principally offer export credit support on commercial terms, such support would not be prohibited but the ECA itself would not be considered a public entity but a 'financial service supplier' covered by the scope of GATS.

XVII GATS still have to be passed.[2540] Without going into detail on the substance of both tests, notice that the fact that other *domestic* service suppliers are likewise excluded from offering official export credit support might question whether both aspects are met.

[2540] Even if a violation is found, it could still be justified on the basis of Article XIV GATS or the Annex on Financial Services (i.e., the prudential carve-out) but these justification grounds seem not directly relevant at first sight.

7. NEGOTIATIONS ON EXPORT CREDIT SUPPORT DISCIPLINES IN THE DOHA ROUND

7.1. NEGOTIATIONS ON EXPORT CREDIT SUPPORT FOR NON-AGRICULTURAL GOODS IN THE DOHA ROUND

Under the SCM Agreement, export credit support for industrial products is principally prohibited if it qualifies as an export subsidy under Article 1 *juncto* 3 or the Illustrative List (items (j) and (k)). Only the safe haven (i.e., OECD Arrangement) or S&D treatment could turn such export subsidies into actionable (and countervailable) subsidies.

In the Doha negotiations, views are strongly divergent on whether or not the *per se* export subsidy standards for export credit support under items (j) and (k), para 1 should be amended. Likewise, WTO Members disagree on whether the link with the OECD Arrangement should be modified (item (k), paragraph 2). Remarkably, while at a certain moment in the negotiations some convergence seemed to emerge given that at least some textual amendments were included in the draft text (November 2007)[2541], a step back is set in the latest circulating draft as it only reproduces the opposing views of Members on both aspects (December 2008). Hence, both elements are now part of the so-called major 'bracketed issues' in the rules negotiations on which WTO Members still fundamentally disagree.

7.1.1. The redrafting of the export subsidy standard under items (j) and (k)

Regarding the *per se* export subsidy definitions in item (j) and the first paragraph of item (k), the Draft Consolidated Chair Text reveals that:

> [EXPORT CREDITS – MARKET BENCHMARKS: Delegations disagree regarding whether the texts of item (j) and the first paragraph of item (k) should be amended to replace the cost-to-government benchmark with one based on benefit-to-recipient. Those favoring such changes consider that the current provisions work to the disadvantage of developing Members and are inconsistent with the Agreement's general definition of "subsidy". Other delegations, however, consider that such changes would increase costs for developing country borrowers, and would reduce predictability for export credit agencies.].[2542]

Apparently, all WTO Members seem to concur that the cost-to-government standard in items (k) and (j), originating from the 1960 Declaration, works indeed against the interest of developing countries, whereas the benefit-to-recipient standard under the Article 1 subsidy definition puts all countries on an equal footing. After all, even the second group of delegations – most likely from developed countries – do not question this conclusion either. Their objections to amending both items merely refer to the predictability for their ECAs operation and to the traditional – but questionable – argument to legitimize export subsidies,

[2541] See Negotiating Group on Rules, *Draft Consolidated Chair Texts of the AD and SCM Agreements* (TN/RL/W/213, 30 November 2007).
[2542] Draft Consolidated Chair Text, above n 2485, at 73.

namely that it benefits importers in developing countries (just as those in developed countries).

Nonetheless, the legal implications of this difference in subsidy standard should be nuanced in light of the case law's rejection of an *a contrario* reading of both items of the Illustrative List. As explained, wiping out the disadvantage to developing countries of the cost-to-government standard was precisely one of the main reasons why panels have systematically rejected that conformity with this standard under the relevant item ((j) or (k)) would imply that such support is *not* prohibited under the SCM Agreement. If such support would result in export credits extended at better-than-market terms to the importer (and thus benefit the exporter), it would still be prohibited on the basis of Article 1 *juncto* 3 of the SCM Agreement. As a result, WTO Members thus already compete on a level playing field with regard to export credit support despite the difference in standards in the current text.[2543] Although the Appellate Body has not yet confirmed whether it would concur, the latest Chair Consolidated Draft Text would codify the panels' interpretation. An *a contrario* reading would only be allowed for 'measures *explicitly* referred to in Annex I as not constituting prohibited export subsidies', which is not present in either item (j) or paragraph 1 of item (k).[2544]

Although WTO Members are thus already confronted with a 'common set of rules'[2545], the call of developing countries to replace the cost-to-government benchmark with one based on the benefit-to-recipient seems nonetheless valid, certainly with regard to item (j). The mandatory/discretionary distinction makes it more difficult to *challenge* an export credit support programme on the basis of the benefit-to-recipient standard (Article 1 *juncto* Article 3) than a similar challenge on the basis of item (j). Arguably, redrafting item (k) along these lines, which was suggested in the draft of December 2007,[2546,2547] would not generate significant legal implications. This change would merely clarify that the ultimate standard is

[2543] Except for S&D treatment for some developing countries.
[2544] See footnote 6 (which replaces the current footnote 5) of the Chair Consolidated Draft Text.
[2545] Panel Report, *Brazil – Aircraft (Article 21.5 – Canada)*, paras 6.60-6.61.
[2546] This draft inscribed a new paragraph 1 of item (k):

> 'The grant by governments (or special institutions controlled by and/or acting under the authority of governments) of export credits at rates below those available to the recipient on international capital markets (absent any government guarantee or support), for funds of the same maturity and other credit terms and denominated in the same currency as the export credit'.

Such an amendment would be nothing more than a codification of the case law on direct credits under the benefit element. Therefore, if the other forms of official financing support would simply be deleted from the Illustrative List, this would have no legal implications. The standard would be similar for direct credits (under the Illustrative List or under Articles 1 and 3 of the SCM Agreement) as for the other types of official financing support (under Articles 1 and 3 of the SCM Agreement). See Negotiating Group on Rules, *Draft Consolidated Chair Texts of the AD and SCM Agreements* (TN/RL/W/213, 30 November 2007), at 76.
[2547] Note that during the Uruguay Round, the US precisely proposed to amend item (k) in a way reflecting the benefit-to-recipient standard. See *Submission by the United States, Elements of the Framework for Negotiations* (MTN.GNG/NG10/W/29, 22 November 1989).

indeed the benefit-to-recipient standard. To be sure, such clarification might be worth advancing *an sich* given that some developed countries (and their ECAs[2548]) do not seem to grasp the scope of the current disciplines. Indeed, the argumentation of their delegates quoted above seems to be based on an erroneous reading of the existing as well as proposed rules. As long as an *a contrario* reasoning of item (j) and the first paragraph of item (k) is rejected (either by continuing the jurisprudence or on an explicit legal basis as foreseen in the same Draft), redrafting items (j) and (k) would neither increase the cost for developing country borrowers nor reduce the predictability for ECAs. After all, even if items (j) and (k) would *not* be redrafted, ECAs will not only have to operate break-even, but should –just like under the current rules –ensure as well that they do not confer export credit support at below market terms by virtue of Article 1 *juncto* 3 of the Illustrative List. Only the safe haven or S&D treatment could preclude that export credit support at subsidized terms is prohibited, though such support would still be vulnerable to an actionable subsidy claim and CVDs actions. In sum, the substantive disciplines on export credit support would not change by replacing the cost-to-government standard under items (j) and (k) with the benefit-to-recipient standard.

7.1.2. The redrafting of the safe haven in paragraph 2 of item (k)

The task of rethinking the unusual character of the safe haven, which was implicitly assigned to WTO Members by the Panel in *Brazil – Aircraft (Article 21.5 – Canada II)*, has not yet resulted in a consensus either. Recall that already during the Uruguay Round developing countries had questioned whether an exception could rest in the hands of developed countries. Even though stronger proposals had been advanced the draft tabled in December 2007 only added a footnote to item paragraph 2 of item (k). This new footnote would have instructed Participants to notify the version of the OECD Arrangement in effect on the date of entry into force of the Doha Development Agreement and allowed the SCM Committee to 'examine' that version upon request.[2549] Thereafter, any new successor undertaking would have to be notified and all WTO Members would again be allowed to request the SCM Committee to examine this new version. In this examination, the SCM Committee would take into account 'the need to maintain effective multilateral disciplines on export credit practices and to preserve a balance of rights and obligations among Members'. The new version would only

[2548] The 2009 report of the Ex-Im Bank also merely refers to the OECD Arrangement as the international framework that has to be respected and to the 'WTO rulings to operate at break-even over the long term'. See Export-Import Bank of the United States, above n 2045, at 13.
[2549] Negotiating Group on Rules, *Draft Consolidated Chair Texts of the AD and SCM Agreements* (TN/RL/W/213, 30 November 2007), at 76-77. See, for example, *Paper from Brazil, Treatment of Government Support for Export Credits and Guarantees under the Agreement on Subsidies and Countervailing Measures* (TN/RL/GEN/66, 11 October 2005).

become applicable once this examination has been completed.[2550] The wording 'examine' seemed to suggest that the SCM Committee would not have to approve the new version before it would become applicable under the SCM Agreement, though this pivotal element was not yet clarified.

In the Draft Consolidated Chair Text of December 2008, however, this textual proposal was deleted, likely because non-OECD Participants considered the fact that new versions were only subject to 'examination' by the SCM Agreement not sufficiently far-reaching. Once more, only the divergence in opinions was described:

> [EXPORT CREDITS – SUCCESSOR UNDERTAKINGS: Views differ widely as to whether the second paragraph of item (k) should be amended such that any changes to the OECD Export Credit Arrangement would not automatically take effect for purposes of the SCM Agreement. At one end of the spectrum, some delegations consider that only amendments not objected to by any Member within a certain period should have legal effect under the second paragraph of item (k), while at the other end of the spectrum some delegations consider that Members should not have any basis on which effectively to veto decisions taken by Participants to the Arrangement.][2551]

The core of the disagreement among WTO Members is thus whether the safe haven could be left in the hands of OECD Participants, or whether other WTO Members could block the entry into force of a new version with respect to its application under the SCM Agreement. The discussion will return to this issue in the concluding normative section.

7.2. NEGOTIATIONS ON EXPORT CREDIT SUPPORT FOR AGRICULTURAL PRODUCTS IN THE DOHA ROUND

7.2.1. Overview of the negotiation process

Contrary to the regulatory framework on export credit support for industrial products, it was ambiguous until the *US – Upland Cotton* decision whether any substantive discipline was in place for such support to agricultural products. This overview of the negotiation process on new disciplines for agricultural export credit support will amply demonstrate that negotiators were clearly unaware that such support is already indirectly subject to the reduction commitments on direct export subsidies.

Article 10.2 of the Agreement on Agriculture obliged WTO Members to start working toward the development of internationally agreed disciplines on export credit support for agricultural products. When WTO negotiations on the reform process of the Agreement on Agriculture were launched in early 2000, negotiations on disciplining export credit support were underway among OECD Participants within the OECD, with mainly the US on the defensive side. But non-OECD Participants such as Argentina, Brazil, and India claimed that the WTO

[2550] If no request for examination is made, the new version would become applicable.
[2551] Draft Consolidated Chair Text, above n 2485, at 74.

was the appropriate forum to negotiate and conclude such disciplines as this would enable participation of all stakeholders (users, recipients, and potentially affected countries).[2552] Other Cairns group members such as Canada and Australia also called to shift negotiations to the WTO. The EC, for its part, was rather neutral on the exact forum but stressed the need for a more 'level playing field in export competition' in the WTO as 'direct' subsidies (listed in Article 9) were subject to reduction commitments, whereas export credit support was, in the EC's view, not subject to any specific discipline given the Article 10.2 mandate had not yet materialised.[2553] Although the US first emphasized that the OECD was the appropriate forum to tackle this issue, it finally realized that it could use any concession in this field to obtain reciprocal concessions of trading partners if the subject was transferred to the WTO.[2554] As a result, negotiations in the OECD broke down[2555] and were taken up in the WTO negotiations under the reform process and subsequently became part of the Doha Round negotiations, which aimed at 'the reductions of, with a view to phasing out, all forms of export subsidies'.[2556]

From the outset, strengthening disciplines on export credit support was a 'widely shared objective'.[2557] The US equally accepted that it was 'on the table' but advocated flexibility

2552 *Proposal by Mercosur, Bolivia, Chile, Costa Rica, Guatemala, India and Malaysia*, *Export Credits for Agricultural Products* (G/AG/NG/W/139, G/AG/W/50, 21 March 2001).

2553 See European Communities Proposal, *Export Competition* (15 September 2000), paras 5-6; Note by the European Communities, *Export Credits* (Brussels, 20 July 2001), paras 1-2; ICTSD, 'Agriculture Negotiations at the WTO: Context Setting and Intelligence Report, February-April 2001' (Geneva, May 2001), at 5 and 16.

2554 *Submission from the United States, Proposal for Comprehensive Long-Term Agricultural Trade Reform* (G/AG/NG/W/15, 23 June 2000), at 4.

2555 The latest draft text circulated in the OECD: *Chairman's Revised Proposal for a Sector Understanding on Export Credits for Agricultural Products, 14-15 November 2000* (TD/CONSENSUS(2000)25/REV4, 9 July 2002). This draft text articulated a general repayment of 180 days, but inscribed an exception for cereals, oilseeds, and cotton with repayment up to 18 months (+ 3 months for export credit support to net-food importing countries). However, Canada and the US failed to overcome their disagreement on this text before a mid-May 2001 ministerial meeting of the OECD, marking the end of the OECD negotiations. Whereas the US signaled that it would have accepted these repayment terms, Canada was only willing to offer 12 months as maximum repayment term for the three products mentioned. On the other hand, Canada was unwilling to accept the US request to make export credit support offered by state-trading enterprises subject to these disciplines. Before these talks with Canada, the Bush administration also came under pressure from Democratic members of Congress not to agree with new disciplines in the OECD as the likelihood of reciprocity would be greater if the topic was integrated in the WTO negotiations. Noteworthy, they recognized the risk that failure to agree would open the door for a challenge of the US export credit support in the WTO but did 'not believe that risk justifies being forced into a bad agreement'. ICTSD, above n 2553, at 5 and 24-25; 'US – Canada Fight Prevents Agriculture Export Credit Deal', 19:16 *Inside US Trade* (20 April 2001).

2556 *Doha Ministerial Declaration* (WT/MIN(01)/DEC/1, 20 November 2001), para 13.

2557 In particular, see also, in addition to n 2553, 2554, 2561, 2564, *Cairns Group Negotiating Proposal, Export Competition* (G/AG/NG/W/11, 16 June 2000), at 2; *Proposal by India in the Areas of (i) Food Security, (ii) Market Access, (iii) Domestic Support and (iv) Export Competition* (G/AG/NG/W/102, 15 January 2001), at 15-16; *Negotiating Proposal by Japan on WTO Agricultural Negotiations* (G/AG/NG/W/91, 21 December 2000), at 15 and 17; *WTO: Negotiations on Agriculture*, *Proposal by Switzerland* (G/AG/NG/W/94, 21 December 2000), at 7; *WTO Negotiations on Agriculture, Proposal by Turkey* (G/AG/NG/W/106, 5 February 2001) at 4; *Comprehensive Proposal by the Arab Republic of* (e.g., on repayment terms),[2558] stated that it would use any concession to push for stricter reduction commitments on direct subsidies, and emphasized that state trading enterprises (e.g., Canadian Wheat Board) should likewise be disciplined.[2559] Conversely, the EC (and the G-10) endorsed the principle of 'full parallelism', indicating that it would only agree on further reductions of direct subsidies (listed in Article 9) if export credit support and other types of indirect export subsidies would be similarly tackled.[2560] The Cairns group also pushed for stringent disciplines as well, but their proposals leave out export credit support offered by state trading enterprises (STEs).[2561] Furthermore, developing countries claimed that new disciplines should give adequate S&D treatment to their support.[2562] Mindful of the Asian financial crisis, some Asian countries, together with the US and Cuba, also advocated that subsidized export credit support could be legitimate in case of currency reserve crises.[2563] Lastly, African countries endorsed the need for stricter disciplines but equally underlined the needs of net-food importing countries and LDCs as they would be hurt by more stringent disciplines on users of such support.[2564] Crafting appropriate S&D treatment for these countries was even explicitly mandated by a ministerial decision (NFIDC Decision).[2565] Although all WTO Members thus agreed on this concern, several developed countries (e.g.,

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Egypt to the WTO Negotiations on Agriculture (G/AG/NG/W/107, 6 February 2001) at 3; *WTO Negotiations on Agriculture, Submission by Croatia* (G/AG/NG/W/141, 23 March 2001), at 3.

2558 It is reported that the US considered the WTO negotiations as a 'totally new ballgame' and thus rejected that the latest draft that had circulated in the OECD would be used as a starting point for the discussion in the WTO. 'US Proposal on Export Credits Likely to Mirror Industry Position', *Inside US Trade* (31 May 2002).

2559 This call by US negotiators was inspired by a paper from its oilseed, grain, wheat, and cotton industries. The paper referred in particular to various forms of export credit support offered by Australia, Canada, France, China, and India and also emphasized that, in light of Article 10.2 of the Agreement on Agriculture, export credit support should not be disciplined similarly as direct export subsidies. Both arguments were picked up by US negotiators. 'WTO Members Split over Approach for Export Credit Disciplines', *Inside US Trade* (7 June 2002); 'US Proposal on Export Credits Likely to Mirror Industry Position', *Inside US Trade* (31 May 2002).

2560 In the words of Pascal Lamy, who was EC trade commissioner at that time, parallelism was 'bound to be the name of the game'. The G-10, a group of countries with high levels of subsidies (see above Part II, Chapter 1, Section 1.5) was in favour of phasing out all export subsidies but also made it conditional on the principle of full parallelism. ICTSD, 'UNCTAD XI: Key Members Report Growing Consensus on Main Farm Trade Issues', 8(21) Bridges Weekly Trade News Digest (16 June 2004), at 1-2; ICTSD, 'Agriculture Negotiations at the WTO 'Framework Phase' Update Report', Quarterly Intelligence Report No. 11 (March 2004), at 5 and 8.

2561 Of course, this is not an accident as some of its main Members have STEs in place (e.g., Canada, Australia and New Zealand). See, for example, *Cairns Group Proposal on Export Credits, Export Credit Guarantees or Insurance Programmes* (JOB(07)/69, 22 May 2007), at 2-3 (compare with the scope of the latest draft discussed below).

2562 For example, *Submission by ASEAN, Special and Differential Treatment for Developing Countries in World Agriculture Trade, Submission by ASEAN* (G/AG/NG/W/55, 10 November 2000), at 2.

2563 ICTSD, 'Agriculture Negotiations at the WTO – "Modalities" Phase Update Report' (Geneva, September 2002), at 14-15.

2564 *WTO African Group: Joint Proposal on the Negotiations on Agriculture* (G/AG/NG/W/142, 23 March 2001), para 16.

2565 *Ministerial Decision on Measures Concerning the Possible Negative Effects of the Reform Programme for Least-Developing and Net Food-Importing Developing Countries*, para 4; Article 16 of the Agreement on Agriculture.

EC, Australia, and New Zealand) as well as some large developing countries (e.g., Brazil, Argentina) warned that this should not open a large loophole. The EC particularly argued that such a loophole would have the perverse effect of increasing developing countries' debt burden. Broadly speaking, these negotiation positions and arguments explain the dynamism of the drafting process until present.

Two different approaches were suggested on how such export credit support had to be disciplined during the first substantive discussions mid 2002.[2566] On the one hand, the Cairns group (sided by the US and several developing countries) proposed a 'rules-based' approach by which commercial terms of all different aspects of such support (i.e. duration, minimum interest rates, and premium rates) would be specified. Export credit support not fulfilling these conditions would be considered 'export subsidies' and made subject to specific reduction commitments or simply be prohibited.[2567] On the other hand, the EC (sided by Norway and Japan) proposed a 'reduction commitment' approach by which the subsidy component of export credit support would be calculated and be brought under the reduction commitments for direct export subsidies. However, the US objected that such calculation was very difficult in practice and that this approach was already unsuccessfully explored in the OECD negotiations.[2568]

In the first draft modalities paper of 2003 (Harbinson Text) already, the choice for the rules-based approach was made. This draft spelled out detailed conditions for export credit support and made non-conforming support subject to 'specific financing reduction commitments'.[2569]

In the July Framework Agreement of 2004, the EC finally agreed upon the elimination of all direct export subsidies by a certain end date. Incorporating the principle of 'parallelism', the Agreement included the elimination of (i) scheduled export subsidies, (ii) export credit support with repayment terms of beyond 180 days, and (iii) export credit support below 180

[2566] See ICTSD, above n 2563, at 14-15.

[2567] ICTSD, 'Agriculture: Little Progress in Export Competition Debate', 6:24 *Bridges Weekly Trade News Digest* (26 June 2002), at 3.

[2568] The EC thus seemed to have changed its mind as it previously pleaded for a 'rules-based' approach in the OECD, but the exact reasons for this shift are unclear. Aggarwal reveals that the EC considered a 'rules-based' approach less transparent than the 'reduction commitment' approach in place for direct subsidies. It was also reported that the EC aimed at diverting the attention from *eliminating* towards *reducing* direct subsidies. Indeed, the 'reduction commitment' approach reflected the EC's plea for full parallelism. Another argument suggested holds that the EC defended this approach because some of its countries had extensive export credit support programmes in place. R. Aggarwal, 'Dynamics of Agriculture Negotiations in the World Trade Organization', 39:4 *Journal of World Trade* (2005), 741-761, at 754; 'WTO Members Split over Approach for Export Credit Disciplines', *Inside US Trade* (7 June 2002).

[2569] Negotiations on Agriculture, *First Draft of Modalities for Further Commitments – Revision* (TN/AG/W/1/Rev.1, 18 March 2003), para 36 and attachment 5. See also *Chairperson's Overview Paper*, above n 2557, paras 33-34 and at 48-57.

days not fulfilling specific disciplines on, *inter alia*, minimum interest and premium rates.[2570] In December 2004, these commitments were incorporated in a new text on export credit support which resembled the Harbinson Text.[2571] Although WTO Members failed to finalize the Doha Round, the EC ultimately agreed in Hong Kong (December 2005) to fix a date for the elimination of export subsidies and all other export measures with equivalent effect.[2572] However, the 2013 end date would only be confirmed once the modalities on export credit support, STEs, and food aid would be completed.[2573]

For the negotiations of these modalities in April 2006, Chairman Falconer suggested to work further along the same lines.[2574] Therefore, Falconer's Reference Paper implemented the rules-based approach, whereby specific disciplines were elaborated. Indeed, the idea was that conforming export credit support would not be considered as 'export subsidies' either for the purpose of the Agreement on Agriculture or any other WTO Agreement. Non-conforming export credit support, on the other hand, would be subject to specific export financing phasing-out commitments. Falconer also emphasized to remain mindful of the entitlement of developing countries 'as actual or potential users of export credits'.[2575] While some questions still had to be solved, the general rules-based approach was no longer disputed. It came thus as a surprise that the EC in reaction to this Reference Paper proposed a 'very different approach', which would only focus on core disciplines and return to a reduction commitment approach.[2576] Whereas the subsequent Draft Possible Modalities on Agriculture (July 2006)[2577] still adhered to the rules-based approach, negotiations ultimately changed track along the lines suggested by the EC as reflected in the latest negotiation text (see below Section 7.2.2).[2578]

Seemingly not the EC's main motivation behind its proposal, a plausible explanation to why the change of track was accepted might be found in the Appellate Body's *US – Upland*

[2570] *The Doha Work Programme – Decision Adopted by the General Council on 1 August 2004* (WT/L/579, 2 August 2004), paras 18-21, 24, 26.

[2571] See ICTSD, 'WTO Agriculture Negotiations Progress on Technical Issues', 8:40 *Bridges Weekly Trade News Digest* (24 November 2004).

[2572] WTO Members further agreed that export credit support up to 180 days 'should be self-financing, reflecting market consistency, and that the period should be of a sufficiently short duration so as not to effectively circumvent real commercially-oriented discipline'. *Hong Kong Ministerial Declaration* (WT/MIN(05)/DEC, 22 December 2005), para 6.

[2573] The Hong Kong Declaration set 30 April 2006 as deadline, but this deadline was clearly not reached.

[2574] *Chair's Reference Paper, Export Credits, Export Credit Guarantees or Insurance Programmes* (13 April 2006).

[2575] *July Framework Agreement*, para 22.

[2576] *Chair's Reference Paper, Rev.1, Export Credits, Export Credit Guarantees or Insurance Programmes* (10 May 2006).

[2577] *Draft Possible Modalities on Agriculture* (TN/AG/W/3, 12 July 2006), Annex I.

[2578] With the important difference that non-conforming export subsidy support is simply prohibited in the latest draft. For the first proposal reflecting the EC's approach, see *Working Document No. 1, Annex D, Possible New Article to Replace the Current Article 10.2 of the Agreement on Agriculture* (6 November 2007). In line with the EC's proposal, non-conforming export credit support was 'to be eliminated within the binding levels of Members' export subsidies elimination Schedules'.

Cotton ruling dating from mid-2005. Apparently, Falconer's Reference Text, incorporating years of negotiations according to the rules-based approach, did not grasp the wider implications of the panel's and Appellate Body's *US – Upland Cotton* ruling. Under Falconer's Reference Text, export credit support conforming to the specific disciplines (e.g., being self-financing) would not be considered an 'export subsidy' and thus would not be prohibited. On the other hand, non-conforming export credit support would, until the date of elimination, not be prohibited as long as it fulfilled specific reduction commitments. Hence, all WTO Members would be allowed to schedule such specific reduction commitments at the end of the Doha Round. However, the Appellate Body had already confirmed that under the existing rules non self-financing export credit support programmes (in the meaning of item (j)) for non-scheduled products are prohibited *as such* and that those for scheduled products are only allowed within existing reduction commitments. Members having no scheduled products simply cannot offer subsidized export credit support. Moreover, even if export credit support programmes would be self-financing under the current rules, they could still be considered 'export subsidies' if conferring a benefit to the exporter (Article 1 *juncto* 3 of the SCM Agreement). Inadvertently, WTO Members targeting mainly US export credit support were thus drafting more flexible instead of more stringent rules on export credit support. Somewhat ironically, the principle of parallelism, fiercely defended by the EC during the negotiations as the 'name of the game'[2579], largely seems to have been already read into the current rules by the panels and Appellate Body.[2580] The shift in approach thus might reflect the awareness among negotiators that subsidized export credit support is, in fact, already indirectly subject to the reduction commitments. At the same time, the fact that countries were unintentionally drafting more flexibility puts further doubt on whether the Panel and Appellate Body indeed interpreted the current rules in line with the original drafters' intention (see Section 5.1.1.1). In the following section, a closer look is taken on how the latest proposal would effectively complement existing disciplines.

7.2.2 Latest draft on disciplines for agricultural export credit support

The most recent Draft Modalities for Agriculture dates from December 2008 and spells out new disciplines in Annex J, which would replace the current Article 10.2 Agreement on Agriculture.[2581,2582]

[2579] See above n 2560.
[2580] Indeed, disciplines on direct subsidies and subsidized export credit support are similar. The only difficulty lies in defining when export credit support is exactly at subsidized terms. The EC seems to hold that 'full parallelism' is not obtained as long as straightforward rules are lacking to make this determination.
[2581] See Revised Draft Modalities for Agriculture, above n 2163, para 165 and Annex J.

The disciplines set out in Annex J further elaborate the export subsidy disciplines that are currently applicable. Indeed, '*(i)n addition* to complying with all other export subsidy obligations under this Agreement and the other covered Agreements'[2583], export credit support should be offered in conformity with Annex J.[2584] Therefore, Annex J cannot be 'construed to imply any change to the obligations and rights under Article 10.1 or to diminish in any way existing obligations under other provisions of the Uruguay Round Agreement on Agriculture or other WTO Agreements'.[2585] Annex J would explicitly stipulate that 'the second paragraph of item (k) of Annex I to the (SCM Agreement) shall not be applicable in the case of agricultural products'. This clarification is at present redundant given that the latest version of the OECD Arrangement to which the second paragraph of item (k) refers does not apply to agricultural products.[2586] Nonetheless, Annex J would unambiguously eliminate any (future) aspirations among OECD Participants to modify the disciplines on agricultural export credit support through item (k) paragraph 2.

7.2.2.1. Scope of new disciplines on export credit support

Export financing support, which is defined broadly,[2587] is disciplined by Annex J if offered by one of the 'export financing entities' established at the national or sub-national level. Parallel to the scope of the SCM Agreement as developed in the case law, it comprises support offered directly by public bodies[2588] as well as indirectly through entrustment or direction of a private body.[2589] Moreover, export credit support is captured in case it is offered by private financial institutions in which there is some form of government participation, even if the government exercises neither control nor direction/entrustment over the private body.[2590] This seems to be looser than the government nexus mandated under Article 1.1(a)(1) of the SCM Agreement and might substantially open the scope of Annex J in light of the various participations taken by governments in response to the current financial and economic crisis. Furthermore, export

[2582] Observe that the 2008 Draft explicitly stipulates with regard to cotton that '(t)o the extent that new disciplines and commitments for export credits, export credit guarantees or insurance programmes, (…) create new and additional obligations for Members as regards cotton, any such obligations shall be implemented on the first day of the implementation period for developed country Members, and by the end of the first year of the implementation period for developing country Members'. See Revised Draft Modalities for Agriculture, above n 2163, para 169.
[2583] Emphasis added.
[2584] This is again reiterated with respect to the condition of self-financing.
[2585] Revised Draft Modalities for Agriculture, above n 2163, para 160.
[2586] Indeed, a precondition for export credit support to be in conformity with the OECD Arrangement is that it is subject to its provisions (Panel Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para 6.61).
[2587] Next to direct financing support and pure cover support, two other types are also explicitly mentioned.
[2588] These are controlled by the government. Panel Report, *Korea – Commercial Vessels*, paras 7.50-7.56, 7.352-7.56.
[2589] Article 2(a),(d) Annex J; Article 1.1(a)(1)(iv) of the SCM Agreement. See also Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 116.
[2590] Article 2(b) of Annex J.

credit support offered by agricultural STEs is explicitly included, mainly on demand by the US and EC.[2591]

7.2.2.2. Substance of new disciplines on export credit support

Reflecting the new 'core disciplines' approach suggested by the EC, only two types of disciplines are imposed on such export financing support.[2592]

First, *the maximum repayment term* of such support is uniformly set on 180 days, regardless of the agricultural product supported.[2593,2594] Accordingly, the exceptions for cereals, oilseeds, and cotton inscribed on demand of the US in the 2000 OECD-draft are not upheld.[2595] More fundamentally, no exception is also made for breeding livestock and agricultural vegetable reproduction material. For these products, a different repayment term was generally considered more acceptable given the longer lifetime of such non-consumable agricultural products.[2596] Only two types of exceptions on the 180 day rule are inscribed, both relating to developing countries. First of all, all developing countries are given a four year phase-in period within which to implement the 180 day rule when they *provide* export financing support. During the first two years, maximum repayment terms of 360 days could be offered and during the next two years, the maximum repayment term is lowered to 270 days.[2597] Next, as mandated by the NFIDC Decision and consistent with economic theory[2598], LDCs and net-food-importing countries are given longer repayment terms when they make *use* of export credit support, but only for the importation of 'basic foodstuffs'. A repayment term between 360 and 540 days *shall* be given and an unspecified 'further extension of such a time frame shall be provided' in case of exceptional circumstances.[2599] Hence, the 180 days rule is even not allowed as repayment term for such export credit support to these countries. Some

[2591] Article 2(c) of Annex J.
[2592] For example, no specific rules on minimum interest rates and transparency are inscribed.
[2593] Already from the beginning of the WTO negotiations, this 180 day rule, transposed from the latest OECD draft, was widely accepted for export credit support offered by developed countries for consumable agricultural goods. *The July Framework Agreement* incorporated this rule.
[2594] The starting point of credit is one of the much debated technical aspects in the negotiations. Similar to the latest OECD draft, 'the "starting point of a credit" shall be no later than the weighted mean date or actual date of the arrival of the goods in the recipient country for a contract under which shipments are made in any consecutive six-month period' (footnote 2 of Annex J).
[2595] As mentioned above (n 2555), this was one of the stumbling blocks for reaching an agreement within the OECD because the US refused to drop these exceptions and Canada refused to leave them untouched. The fact that the US did not really hold to these exceptions in the WTO talks supports the theory that the US refusal in the OECD was in fact a tactical move to shift discussions to the WTO.
[2596] Here again, the latest OECD draft offered longer maximum repayment terms for breeding cattle (2 years for contracts up to $150 000 and 3 years for contracts exceeding $150 000) and agricultural vegetable reproduction material (1 year).
[2597] After four years, the normal 180 days rule shall apply.
[2598] But other options would be superior (see below Part III, Chapter 8, Section 8.2)
[2599] It should be exceptional circumstances 'which still preclude financing normal levels of commercial imports of basic foodstuffs and/or in accessing loans granted by multilateral and/or regional financial institutions within these timeframes'.

countries' reluctance to open a large loophole thus seems to have blocked the option to completely exempt export credit support to LDCs and net food-importing countries.[2600]

Second, all export financing support programmes except for direct financing support have to be *self-financing*. In particular, such a programme will be considered as not self-financing if premium rates inadequately cover operating costs and losses of that programme over a previous 4-year rolling period.[2601] With respect to support offered by developing countries, this rolling period is specified at 6 years. Alternatively, a programme will also be considered not self-financing under Annex J if it fails to respect the unspecified 'long-term operating costs and losses' standard of item (j) of the Illustrative List.

If export credit support does not conform to the maximum repayment terms and/or the self-financing obligation, it is considered inconsistent with Annex J. In contrast to previous drafts, such non-conforming export credit support is not made subject to the reduction commitments for direct export subsidies or made subject to specific reduction commitments. Instead, it is simply prohibited. By consequence, such export credit support inconsistent with the Agreement on Agriculture will also be challengeable under Article 3 of the SCM Agreement.[2602]

7.2.2.3. Evaluation of new disciplines on export credit support

How should these substantive conditions that would be imposed under Annex J be appreciated in light of the 'subsidy'-standards spelled out in the SCM Agreement and of the disciplines imposed on other agricultural export subsidies? Three aspects of Annex J disciplines could be analyzed in this respect.

First, how should the maximum repayment terms under Annex J be evaluated in light of commercial practice? Although not necessarily reflecting commercial conditions, the Berne Union General Understanding could offer a useful initial touchstone. It elaborates an understanding among Berne Union Members, which comprises of public as well as private providers of pure cover support, regarding *inter alia* terms of payment.[2603] The Berne Union General Understanding stipulates that 'it is normally sound underwriting practice for credit terms to be related to the nature of the goods and to be in line with sound conditions normally

[2600] Given the fact that 'only a tiny percentage of credits' actually go to these Members, Falconer had nonetheless suggested not to unduly over-rate the risk of creating such a loophole. *Chair's Reference Paper,* above n 2576, at 6.

[2601] This rolling period was highly debated among the US and EC, suggesting 15 years and 1 year respectively.

[2602] In order to find a violation of this provision, the existence of an export subsidy in the meaning of Article 1 *juncto* 3 or the Illustrative List (item (j) or (k)) will have to be demonstrated.

[2603] Berne Union Agreements, *Understandings and Obligations in the Export Credit Insurance Field – General Understanding* (Berne Union General Understanding) (January 2001). See also Background Paper by the Secretariat, above 2162, paras 19-21, 27, 38.

accepted in the market'.[2604] Agricultural products are not treated separately. Consumable agricultural products would be covered by the category of 'consumable goods'[2605] for which a maximum term of six months is inscribed. This corresponds with the 180 days rule inscribed in Annex J for export credit support offered by developed countries and would, for example, imply that the US would have to substantially shorten its maximum repayment terms (up to three years) under its GSM-102 programme. Under 'Sector Agreements' of the Berne Union Understanding, repayment terms are specified for non-consumable agricultural products. For breeding animals, 180 days is the general rule but 2 or even 3 years repayment terms are allowed for cattle depending on the contract value. For agricultural vegetable reproduction material, maximum terms are even permitted up to 360 days. This flexibility on the 180 days rule for non-consumable agricultural products foreseen in the Berne Union Understanding would, however, not be allowed under Annex J.[2606] Hence, regardless of whether terms beyond the 180 days rule would be offered in commercial practice, export financing entities, including private institutions in which governments have a participation, are mandated to limit export financing support for non-consumable agricultural products up to the 180 days repayment term. Compared to the six months repayment term, the term developing countries are allowed to offer during a transitional period (360 days and 270 days) as well as the term mandated for such support for the importation of basic foodstuff in LDCs and net-food importing countries (between 360 and 540 days) clearly do not correspond to commercial practice and are thus at 'subsidized terms'.

Second, Annex J defines a specific previous 4-year rolling period to assess whether pure cover support is self-financing. This is substantially shorter than the long-term period effectively taken into account in the *US – Upland Cotton* case under item (j) and on which basis the US also defined a long-term period as a 'period of ten years or more' in its 2008 Farm Bill.[2607] In contrast, under Annex J, the programme should be self-financing over a strict previous 4-years period even if atypical experiences have occurred. Obviously, the shorter the self-financing term, the more difficult it is to compensate losses during a certain period of time with profits during another period of time. Furthermore, a well-defined short self-financing term also facilitates monitoring and challenging an export credit programme and seems sensible as the focus should be on the *actual* operation of the export credit programme.[2608,2609] To be sure, Members are still allowed to rely on the unspecified 'long-

[2604] Article III of the Berne Union General Understanding.
[2605] Article V(b) of the Berne Union General Understanding.
[2606] Except for developing counties during the implementation phase.
[2607] See above n 2462.
[2608] Because repayment terms are set at a maximum of 180 days, adequacy of charged premiums could be meaningfully assessed over a relatively short period.

term' period of item (j) to demonstrate that a programme is not self-financing under Annex J. In this way, quantitative evidence related to future projections and non-quantitative evidence are still relevant. By inscribing self-financing as one of its core obligations, however, Annex J incorporates a cost-to-government standard which is inherently disadvantageous for developing countries.[2610,2611] This disadvantage seems only partly counterbalanced by a longer self-financing period for developing countries.[2612]

Third, non-conforming support is inconsistent with Annex J and thus not made subject to the reduction commitments for direct subsidies or to specific reduction commitments, whereas direct export subsidies are allowed insofar reduction commitments are respected until the final elimination date. Hence, the current draft goes well beyond the principle of 'full parallelism'.

Generally speaking, Annex J disciplines are more stringent than those actually imposed under Article 10.1 Agreement on Agriculture. But export credit support fulfilling those aspects of Annex J that are less demanding could still be challenged on the basis of Article 10.1 because Annex J disciplines are formulated as additional. For example, Annex J conforming export credit support could still be challenged as conferring a benefit to the recipient in the meaning of Article 1 SCM Agreement. Such export credit support violates the Agreement on Agriculture and the SCM Agreement if offered to unscheduled products and to scheduled products above reduction commitment levels. This raises the question as to the value of the flexibility that would explicitly be offered under Annex J. Developing countries are allowed to offer repayment terms at non-commercial – and thus subsidized – terms during a

[2609] As an illustration, the US conceded before the Panel in *US – Upland Cotton* that its programmes historically incurred significant losses with respect to Poland and Iraq that were no longer reflected in accounts relating to cohorts since 1992. However, the US asserted that to subject the programme to the 'analytical yoke' of the unique circumstances of the Polish and Iraqi defaults over 10 years ago would effectively require elimination of the programme altogether. Although this pre-1992 period was not taken into account, it illustrates that an export credit programme could qualify as not self-financing if a long-term period is considered, simply because it operated at a significant loss at times which seem not particularly relevant anymore for assessing current subsidization. See Panel Report, *US – Upland Cotton*, para 7.830.

[2610] Theoretically, this disadvantage would be neutralized in case disciplines on minimum *interest* rates would be established with respect to export credits benefiting from pure cover. Disciplines on minimum interest rates were inscribed in previous drafts but only for official *financing* support and not for export credits benefiting from *pure cover support*. Noteworthy, under the OECD Arrangement no minimum interest rates are inscribed for pure cover support either, which explains why the safe haven of item (k), para 2 is not available for pure cover support at the moment.

[2611] An open question is whether a violation of Annex J would imply that the WTO Member in question also has to ensure that the benefit-to-recipient standard is met. If so, part of the disadvantage resulting from the cost-to-government standard would be neutralized (recall also above n 2481).

[2612] As under the current regime, the disadvantage is partly tempered by the benefit-to-recipient standard that is still available for an assessment under Article 10.1. Contrary to Annex J, Article 10.1 only outlaws such subsidized pure cover support above reduction commitment levels. Moreover, the long-term period spelled out in item (j) is inscribed in Annex J and makes no distinction between developed and developing countries.

transitional period. As these countries often do not have scheduled products, such 'export subsidies' in the meaning of Article 1 *juncto* 3 SCM Agreement would nonetheless be inconsistent with Article 10.1 of the Agreement on Agriculture and Article 3 SCM Agreement. Of parallel note, all countries are *required* to offer longer repayment terms to net-food importing countries and LDCs for their importation of basic foodstuffs. Hence, an export credit programme tailored to these countries would even mandate export credit support at subsidized terms and would thus be vulnerable to an *as such* claim. Again, such export credit support at subsidized terms violates Article 10.1 of the Agreement on Agriculture if extended above commitment levels.

8. CONCLUSION: NORMATIVE ANALYSIS OF DISCIPLINES ON EXPORT CREDIT SUPPORT

8.1. OVERVIEW AND NORMATIVE ANALYSIS OF DISCIPLINES ON EXPORT CREDIT SUPPORT FOR NON-AGRICULTURAL PRODUCTS

Export credit support provided by ECAs that aims at filling in gaps left by the private financial market could be labeled as an export subsidy and is thus in principle prohibited under the SCM Agreement. Mindful of the position of developing countries, panels declared that subsidized export credits fall under this prohibition even if no cost to the government is involved.[2613] Consequently, the urge by the WTO upon its Members to spur export credits to developing countries in general and in light of the financial crisis in particular, can only be in accordance with the SCM Agreement if an exception for this prohibition is provided for.[2614] Such an exception available to all WTO Members is spelled out in the form of a 'safe haven' under paragraph 2 of item (k) Illustrative List, which refers to the OECD Arrangement. By leveling the playing field among ECAs, the OECD Arrangement would neutralize the trade-distortive potential of export credit support if exporters in different countries have access to export credit support at the terms set in the latest version of the OECD Arrangement.[2615] But WTO Members should be aware of the exact scope of this safe haven. First, it only shields official financing support with repayment terms of at least two years and fixed interest rates. Thus, ECAs are prohibited to extend short-term export credits for non-agricultural goods which aim at filling the gap in short-term financing caused by the financial crisis.[2616] Moreover, pure cover support is not accepted as long as the supported export credits are not made subject to the CIRR. If such support is not available at the private market – which is often the case –, pure cover support is prohibited under the SCM Agreement as well. The argument that the guarantee/insurance programme runs at no cost to the government, as prescribed by item (j) of the Illustrative List (and the OECD Arrangement), is irrelevant as a defence since no *a contrario*-reasoning is accepted. Hence, at present, ECAs can not play their complementary role in providing pure cover support. Second, matching of derogations, even though permitted under the OECD Arrangement, is not allowed under the SCM Agreement. In this case, export credit support cannot be used as a self-defence instrument.

[2613] By rejecting an *a contrario* reading of items (j) and (k), para 1.
[2614] Unless all support is channelled through international organizations.
[2615] Here, the term 'trade-distortive' is used in the meaning of altering trade flows and not in the meaning of creating extra trade above the free trade level. The trade-creating effect is exactly legitimized on the basis of capital market failures.
[2616] In the *US – Upland Cotton* arbitration procedure, the US cited the call for more trade finance support made in the WTO Expert Group Meeting on Trade Finance to underpin its claim that Brazil's request for countermeasures had to be considered in the context of the financial crisis and the need for credit availability. However, Brazil correctly responded that the disciplines do 'not change in times of crisis' and subtly highlighted that the US had agreed with this position in *Korea – Commercial Vessels*. Written Submission by the United States (9 December 2008), at 3-4; Written Submission by Brazil (13 January 2009), at 25 – 27.

Instead, WTO Members have to take recourse to the WTO dispute settlement system.[2617] Third, export credit support covered by the safe haven is still countervailable and might also be challenged as an actionable subsidy.

In addition to this safe haven, subsidized export credits, even if not in line with the OECD Arrangement, are not prohibited if offered by developing countries listed in Annex VII,[2618] though such support could still be actionable and countervailable under certain conditions. In these countries, ECAs have policy space to play a complementary role in providing pure cover support and to use subsidized export credit support as an export-promoting tool. Hence, Aid for Trade to set up ECAs in those countries would be WTO-compatible. As other WTO Members are not allowed to match support at below OECD Arrangement terms, exporters in these countries might also benefit from stringent disciplines imposed on other WTO Members.[2619]

Finally, trade financing support offered by regional and international financial institutions for trade transactions with developing countries would likely not be subject to the obligations set by the SCM Agreement. These institutions look at export credit support from the perspective of the importer or exporter in the developing country eligible for development assistance. In general, all foreign exporters could apply for export credit support for their sales to these developing countries (import transaction). In contrast to individual ECAs support, this support is thus not contingent upon exportation from a *particular* country. Hence, such support would only be trade-distorting in the meaning of trade enhancement above the free trade level, but this could be perfectly legitimized on the basis of capital market failures in these importing developing countries. On the other hand, only exporters of eligible developing countries may apply for export credit support (export transaction). If such export credit support would fall outside the scope of the SCM Agreement, exporters from developed countries might qualify this as unfair competition because the same export credit support offered by its ECAs is disciplined by the SCM Agreement. But for those eligible countries that benefit from S&D treatment under the SCM Agreement, export credit support would in any case be subject to more flexible rules. Next to this legal argument, the presence of more fundamental capital market failures in eligible developing countries might offer an economic justification for such support targeted at their exporters.[2620] In sum, the exclusion from the

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[2617] Or, they could impose CVDs to tackle the injury to their domestic industry.

[2618] Unless they have graduated from Annex VII.

[2619] Obviously, importers in developing countries would benefit from flexible rules imposed on export credit support offered by foreign ECAs.

[2620] Hence, such support (like the one offered under the TFFPs) would rather level the playing field than confer an unfair advantage upon these developing countries' exporters. Moreover, it would be less trade-distorting than support offered by individual ECAs, because exporters of *all* eligible developing countries are able to receive support at these terms. Lastly, it could also be justified on the basis of market failures outside the capital market (e.g., export promotion tool; see above Part I, Chapter 2, Section 2.4.3; below Part IV, Chapter 3, Section 3.2.1).

disciplines under the SCM Agreement of export credit support offered by multilateral financial institutions holds water from both a legal as well as an economic perspective.[2621]

Turning back to export credit support offered by individual countries, ECAs in developed and higher-income developing WTO Members are thus only able to play a complementary role in trade financing for non-agricultural goods insofar provided for in the safe haven. The fact that this lays in the hands of OECD Arrangement Participants was no concern as long as disciplines mainly targeted their export credit support. Yet, developing countries not listed in Annex VII currently have to conform to the most recent version of the OECD Arrangement to justify subsidized export credits, even though they do not participate in its revisions. By revising the arrangement, OECD Participants recently attempted to bring something 'simply inconsistent with the overarching principles and purposes of the WTO Agreement and the SCM Agreement' under the safe haven.[2622] This plainly demonstrates that an exception 'left in the hands of a certain *subgroup* of WTO Members' seems unjustifiable.[2623] From the perspective of the OECD Export Credits Secretariat, 'the main challenge for the OECD-based disciplines applicable to export credits is to remain relevant, robust and flexible in order to meet Members' policy objectives and to be compatible with their other international obligations'.[2624] From the perspective of developing countries, this challenge is only justifiable if it is put on the shoulders of a multilateral institution such as the WTO.

8.2. OVERVIEW AND NORMATIVE ANALYSIS OF DISCIPLINES ON EXPORT CREDIT SUPPORT FOR AGRICULTURAL PRODUCTS

One of the objections articulated by the US before the Panel in *US – Upland Cotton* was that Brazil's interpretation would imply that export credit guarantees would be subject to more disciplines than any other practice in the Agreement on Agriculture. Export credit support would not only be subject to the obligations on export subsidies but also to additional disciplines that would be developed under Article 10.2 of the Agreement on Agriculture in the future.[2625]

The thrust of this argument turned out to be accurate. The case law has read subsidized export credit support into the scope of Article 10.1 of the Agreement on Agriculture and interpreted the anti-circumvention requirement in a way that made such support indirectly subject to commitments for listed types of subsidies. Subsidized export credit support is even

[2621] Moreover, developed countries will in practice not allow that such export credit offered by multilateral institutions would seriously undermine their export interests.

[2622] This refers to the amendment made regarding matching of derogations. Panel Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para 5.140.

[2623] Panel Report, *Canada – Aircraft (Article 21.5 – Brazil)*, para 5.132.

[2624] See Export Credits Secretariat, above n 2033.

[2625] Panel Report, *US – Upland Cotton*, above n 1738, WT/DS267/R/Add.1, Annex D, at D-17, D-32; Annex E, at E-14.

scrutinized more severely than listed types of export subsidies as a ‘threat’ of circumvention suffices to find a violation of Article 10.1 of the Agreement on Agriculture. Bringing subsidized export credit support under Article 10.1 implies that it could simply not be offered by those Members having no listed types of export subsidies, while others, mostly developed countries, could offer it up to their reduction commitment levels. This ‘inverse’ S&D treatment is further reinforced by the cost-to-government standard, which might not be fully neutralized by the potential application of the benefit-to-recipient standard. To be sure, the only advantage for developed countries in this respect is that complaining Members will more often have to take recourse to the more demanding benefit-to-recipient standard since developed countries’ programmes are more easily cost-recovering.[2626]
Apparently, negotiators were also surprised by the interpretation offered in *US – Upland Cotton* as they were drafting more flexible rules. But the latest negotiation text shows that they are now on track for drafting additional rules. If this draft would be adopted, support not fulfilling the core disciplines on maximum repayment terms and self-financing would be outlawed *as such*. The different treatment of WTO Members depending on whether they have scheduled products or not is thus largely deleted.[2627] Although offered limited flexibility in terms of a longer self-financing period, developing countries are still disadvantaged by the cost-to-government standard reflected in the self-financing obligation. Furthermore, the temporal flexibility on repayment terms under Annex J seems of limited legal value as such subsidized support would be outlawed under the ‘additional’ Article 10.1 obligation.[2628]

In sum, future disciplines would go beyond the principle of ‘full-parallelism’ and this principle is to a large extent already read into the current rules in the case law. Contrary to certain forms of export credit support for non-agricultural products, there is no – and there will not be – any explicit ‘safe haven’ for subsidized export credit support for agricultural products. Policy space allowing Members to play a complementary role to the private market seems less mandatory in the field of agricultural export credits as these mostly take the form of short-term credits for which private trade financing instruments are usually well developed.[2629] Yet, this conclusion might have to be nuanced in a double way. First, today’s experience shows that these private short-term export credits could quickly run dry in times of financial crisis. The existing rules only allow those countries that have scheduled products (and up to reduction commitments) to offer export credit support for agricultural products

[2626] Remind that the Arbitrator in *US – Upland Cotton* decided that implementation encompasses the benefit-to-recipient standard if a violation of item (j) has been found.
[2627] It could still play a role under the additional claim on the basis of Article 10.1.
[2628] This holds unless the developing country in question has scheduled agricultural products.
[2629] This might have to be nuanced for developing countries where a developed private financing market would be lacking.

filling in the gap left by the private trade financing market. No flexibility to tackle such situations is foreseen in the latest draft negotiating text. Second, in normal circumstances, policy space for subsidized export credit support could be considered legitimate to spur urgently needed food imports in LDCs and net-food importing countries. Whereas current disciplines do not distinguish between recipient countries, the latest negotiating draft would mandate longer repayment terms for export credit support to importers of basic foodstuff in LDCs and net-food importing countries. But once more, the legal value of such flexibility is doubtful as Article 10.1 does not allow WTO Members to offer subsidized export credits above reduction commitment levels. In both circumstances (i.e., financial crisis and exports to net-food importing countries), the optimal strategy would again not take the form of subsidized export credit support by ECAs. Instead, unbound food aid in cash form or export credit support offered by international organizations would be superior as these strategies would de-link support from exportation of a particular country.[2630] Both policy options would not only be superior in economic terms but would also be justified in legal terms.

Although questionable from a *legal* perspective, reading substantive disciplines on agricultural export credit support in the current provisions – as the WTO-adjudicating bodies have done – as well as drafting even more stringent disciplines in the way WTO Members are doing now should thus generally be welcomed from a *policy* perspective. But this objective is only legitimate insofar S&D treatment is not put upside down and insofar as rules are articulated coherently.

[2630] On international food aid, see above Part II, Chapter 6, Section 6.2.1.2.3.

PART IV

NORMATIVE ANALYSIS OF DISCIPLINES ON SUBSIDIZATION AND THE IMPOSITION OF COUNTERVAILING MEASURES

INTRODUCTION

In this concluding Part, the appropriateness of the balance between 'policy space' and 'policy constraints' in WTO disciplines on subsidies and countervailing measures is assessed. This normative analysis of the SCM Agreement and Agreement on Agriculture is based on the premise that these trade agreements should help countries to foster global welfare. To perform this normative assessment, insights generated under the previous Parts are confronted.

In Part I, we explored why governments subsidize even though welfare theory shows that, under the perfect market assumption, this would contract their own welfare. Complementary, Part I analyzed why other countries would respond on subsidized imports by imposing CVDs as this unilateral action likewise depresses their welfare. Both puzzles were solved by taking market imperfections, political-economy arguments, and other non-economic rationales into account. This economic analysis illustrated why governments *de facto* undertake both types of interventions (positive theory) and why these measures would be legitimate (normative theory). The discussion revealed that policy space to offer subsidies could very well be important to spur economic growth and sustainable development in general. At the same time, it was explained that governments could de facto be merely motivated to meet special interest groups' narrow interests when considering subsidization or CVDs action.

In Part II, the legal analysis started by tracing the origins of the current WTO disciplines. This historical overview shed light on why countries have been willing to conclude trade agreements that put restrictions on their freedom to subsidize and adopt CVDs. Next, Part II scrutinized the actual scope of existing disciplines on subsidization under both the SCM Agreement and the Agreement on Agriculture. Here, the multilateral as well as the unilateral track available to WTO Members to respond to foreign subsidization were explained. The case study on export credit support developed in Part III further specified the existing regulatory framework.

Based on these economic and legal analyses, this concluding Part provides an integrative discussion on relevant issues touching upon the equilibrium between policy space and policy constraints. After assessing concerns that have been raised on the scope of the SCM Agreement (Chapter 1), the discussion will turn to an evaluation of the regulatory regime applicable to developed countries (Chapter 2) and developing countries (Chapter 3), respectively. Next, the question is addressed whether the existing leeway for unilateral CVDs action under the SCM Agreement could be considered justified (Chapter 4). Finally, this Part goes into the current debate on whether governments' interventions in response to the financial and economic crisis have raised concerns on the reach of present WTO disciplines (Chapter 5).

1. THE SCOPE OF THE SCM AGREEMENT: SPECIFIC SUBSIDIES

A specific subsidy exists under the SCM Agreement when a government makes a financial contribution or provides income or price support that confers a benefit to a specific recipient. The case law developed the 'private market test' to detect whether a financial contribution (or income or price support) indeed benefits a specific recipient. The 'specific subsidy'-definition filters out whether a specific recipient has received such contribution (or support) at better than market terms.

In general, three lines of concern are articulated on this 'specific subsidy'-definition as inscribed in Articles 1 and 2 of the SCM Agreement and further drawn upon in the case law. First, not all government measures with *similar* trade-distorting *effects* are disciplined in the same way. Second, subsidies with a *corrective* rather than distortive *effect* on markets are disciplined similar as those having no objective to correct market failures. Third, by disregarding the effect on the recipient's competitive situation, measures having *no* trade-distorting *effect* could be covered under the subsidy definition and privatization might extinguish subsidization even though the trade-distorting *effect* is still present.

Before addressing these three concerns, recall that the SCM Agreement does not outlaw the provision of specific subsidies covered under Articles 1 and 2 of the SCM Agreement *as such*. The definition serves a double purpose: it opens the door to the substantive disciplines on subsidies but at the same time limits the measures against which WTO Members could take CVDs action. Part of the criticism related to the subsidy definition might be better tackled under the disciplines imposed upon such subsidies. Other lines of concern might seem to be unavoidable in light of the subsidy definition's threshold function.

1.1. FINANCIAL CONTRIBUTION ELEMENT: NATURE OF THE SUBSIDY

1.1.1. Closed list of government interventions

Article 1 of the SCM Agreement offers an exhaustive list of government interventions that could be qualified as a 'subsidy' under the SCM Agreement if they confer a benefit. In the words of the Appellate Body, the financial contribution element 'involves consideration of *the nature* of the transaction through which something of economic value is transferred by the government'.[2631] Generally speaking, panels and the Appellate Body have offered a rather expansive interpretation of the three types of financial contribution (Article 1.1(a) of the SCM Agreement), whereas they seemingly endorsed a narrow reading of 'income or price support' (Article 1.1(b) of the SCM Agreement). Governments could subsidize by *positive* action when transferring monetary or non-monetary resources directly or indirectly through private

[2631] Appellate Body Report, *US – Softwood Lumber IV*, para 52 (emphasis added).

actors. Alternatively, they could subsidize by *negative* action when refraining to collect revenue otherwise due. Only two types of government interventions are explicitly excluded from the subsidy-definition: the provision of general infrastructure, which in essence relates to the specificity element, and border tax adjustments on indirect taxes and import duties.[2632]

The closed list inscribed in Article 1 of the SCM Agreement implies that other government measures generating similar effects are not covered under the SCM Agreement.[2633] For instance, the Panel in *US – Export Restraints* correctly concluded that export restraints are not captured, even though such measures could very well benefit domestic producers (in this case downstream producers) in a similar way than in case a financial contribution is offered.[2634,2635] Moreover, the financial contribution element does equally exclude so-called 'regulatory subsidies' from the scope of the SCM Agreement. This refers to the failure of a government to provide certain levels of regulation on, for instance, environmental protection or labor standards.[2636] Such negative action by the government cannot be labelled as a subsidy because there is no (potential) direct transfer of funds (or liabilities), provision of goods or services, or revenue that is foregone.[2637] This implies that such 'regulatory subsidies' (so-

[2632] See Article 1.1(a)(1)(iii) of the SCM Agreement and footnote 1 of the SCM Agreement.
[2633] Remind that export subsidies included in the Illustrative List are prohibited, regardless of whether they are covered under Article 1 of the SCM Agreement.
[2634] Panel Report, *US – Export Restraints*, para 8.75.
[2635] Janow and Staiger offer an alternative reasoning on which ground the US claim could be rejected. Applying the Lerner Theorem, they indicate that an export tax is equivalent to an alternative programme in which an export subsidy of the same magnitude is placed on every other export good and an import tariff of the same magnitude is placed on each imported good. On this basis, they argue that an export tax confers a subsidy to production in *every* other sector of the economy. Therefore, the Panel could have rejected the US claim on the basis of the specificity test. Yet, their argument seems flawed in legal terms because, even if the export tax generates these non-specific benefits to all other sectors, it still confers a *specific* benefit for downstream domestic producers as they benefit from a reduced domestic price. Hence, the specificity test will still be passed. As Janow and Staiger acknowledge as well, their equivalence argument 'does not for example rule out the possibility than an export tax on logs would have a large expansionary impact on the volume of exports of logs (…)'. Sykes also indicates that, from an economic point of view, Janow and Staiger's view does not refute that an export tax benefits downstream producers. J. Janow and R. W. Staiger, 'US – Export Restraints, United States – Measures Treating Export Restraints as Subsidies (WT/DS194; DSR 201:XI, 5767)', in H. Horn and P. Mavroidis (eds), *The American Law Institute Reporters' Studies on WTO Case Law – Legal and Economic Analysis* (Cambridge: Cambridge University Press, 2007), 214-248, at 242-244; A. O. Sykes, 'The Questionable Case for Subsidies Regulation: A Comparative Perspective', *Working Paper* (April 2009), 41 pp, at 30.
[2636] See, for example, J. H. Jackson, *The World Trading System: Law and Policy of International Economic Relations*, 2nd ed (Massachusetts: MIT Press, 1997), 441 pp., at 296; P. C. Mavroidis, P. A. Messerlin, and J. M. Wauters, *The Law and Economics of Contingent Protection in the WTO* (Cheltenham: Edward Elgar, 2008), 606 pp., at 303; M. Schlagenhof, 'Trade Measures Based on Environmental Processes and Production Methods', 29:6 *Journal of World Trade* (1995), 123-155, at 145-146.
[2637] It could also not be considered as income or price support under 1.1(a)(2) of the SCM Agreement.

called 'social dumping') cannot be countervailed by importing countries.[2638,2639] For example, developing countries could implement the 2008 Growth Report's suggestion to allow export-oriented firms to recruit workers on easier terms (e.g., in export processing zones) than those prevailing in the formal sector so as to overcome labor market failures (i.e., surplus labor) without any risk of unilateral or multilateral action by other WTO Members.[2640] Lastly, an undervalued exchange rate (so-called 'exchange dumping') does, according to most scholars, not qualify as a specific subsidy under the SCM Agreement even though it has a similar effect as an export subsidy across the board.[2641]

Hence, the relevance of the closed list included in the SCM Agreement is its limiting of the scope of government measures that can be *countervailed* and are *disciplined* under the SCM Agreement. Indeed, as stressed by the Panel in *US – Export Restraints*, the 'financial contribution'-requirement was precisely advocated by most countries to counter the purely effect-based definition of the US, under which any government measure having the effect of benefiting domestic producers could in theory be countervailed.[2642] By somewhat downplaying the scope of 'income or price support', the case law seems to foreclose that an effect-based approach would be introduced under this alternative for the financial contribution element. In my opinion, the rejection of an effect-based approach is legally sound. After all, if 'all government measures capable of conferring benefits would necessarily fall within Article 1.1(a)', there 'would be no need for Article 1.1(a), because all government measures conferring benefits, *per se*, would be subsidies'.[2643] At the same time, such a closed list

[2638] Already during the initial GATT negotiations, such 'social dumping' was discussed. This referred to prison labor or sweated labor resulting in low prices. It was agreed that anti-dumping duties could only be imposed with regard to 'price dumping'. As a result, neither CVDs nor anti-dumping duties can be imposed to counteract such regulatory subsidies. See *Committee II – Summary record of technical Sub-Committee* (E/PC/T/C.II/48, 11 November 1946); *Committee II – Draft report of the technical Sub-Committee.* (E/PC/T/C.II/54, 16 November 1946).

[2639] This limited scope of the SCM Agreement is not always acknowledged in the economic literature. See, for example, J. Stiglitz, 'A New Agenda for Global Warming', 3:7 *The Economists' Voice* (2006), 1-4.

[2640] See above Part I, Chapter 2, Section 2.2.2. Commission on Growth and Development, *The Growth Report – Strategies for Sustained Growth and Inclusive Development* (Washington DC: The World Bank, 2008), 190 pp., at 45-48; see also R. A. Torres, 'Free Zones and the World Trade Organization Agreement on Subsidies and Countervailing Measures', 2:5 *Global Trade and Customs Journal* (2007), 217-223, at 218.

[2641] See below Part IV, Chapter 3, Section 3.2.3.

[2642] Panel Report, *US – Export Restraints*, para 8.75. During the Uruguay Round, the US proposed to define the term '(actionable) subsidy' as 'any government action or combination of actions which confers a benefit on the recipient firm(s)'. See *Submission by the United States, Elements of the Framework for Negotiations* (MTN.GNG/NG10/W/29, 22 November 1989), section II.1(a). See also Appellate Body Report, *US – Softwood Lumber IV*, para 52, footnote 35.

[2643] Appellate Body Report, *US – Softwood Lumber IV*, para 52, footnote 35. At the same time, this Appellate Body report also underscored that the scope of Article 1 is 'broadened still further' by the concept of 'income or price support' (para 52).

carries the risk that WTO Members might shift to government measures that do not qualify as a subsidy but that generate equivalent effects.[2644,2645]

Yet, the list as interpreted in the case law is sufficiently broad to capture the most common forms of subsidies. Indeed, as underscored by the Appellate Body, 'a wide range of transactions falls within the meaning of "financial contribution" in Article 1.1(a)(1)'.[2646] Next, one might wonder whether those government actions falling outside its current scope really ought to be disciplined under the SCM Agreement.[2647] Export restraints in the form of non-fiscal measures are principally outlawed under Article XI of the GATT, whereas export taxes could be scheduled under Article II of the GATT and could thus be subject to tariff negotiations.[2648] Moreover, as Sykes indicates, allowing export restraints to be labelled as 'subsidies' would generate difficulties in quantification and raise the question whether any regulation that lowers the price of inputs would be treated similarly.[2649] More fundamentally, with regard to the so-called 'social dumping' or 'exchange dumping': what level of regulation or exchange rate would be appropriate (i.e., non-beneficial) under the SCM Agreement? How would WTO-adjudicating bodies or WTO Members wishing to respect their WTO obligations define the appropriate benchmark in the absence of specific guidance?[2650] Rather than

[2644] See, for example, L. Rubini, 'The International Context of EC State Aid Law and Policy: The Regulation of Subsidies in the WTO', in A. Bondi, P. Eeckhout, and J. Flynn (eds), *The Law of State Aid in the European Union* (Oxford: Oxford University Press, 2004), 149-188, at 160.

[2645] Luengo's broad interpretation of the concept of 'income or price support' would *de facto* seem to open the list to government measures having an equivalent effect. In his interpretation, government measures such as export restrictions that directly or indirectly have an impact on the income of the recipient would be covered. See G. Luengo, *Regulation of Subsidies and State Aids in WTO and EC Law* (The Netherlands: Kluwer Law International, 2006), 586 pp., at 119-123. Rubini also observes that 'income or price support' might likely be interpreted by future panels in a way that, for example, export restraints would be covered. See L. Rubini, *The Definition of Subsidy and State Aid – WTO and EC Law in Comparative Perspective* (Oxford: Oxford University Press, 2010), 484 pp., at 123-125.

[2646] Appellate Body Report, *US – Softwood Lumber IV*, para 52.

[2647] Disciplines on export restraints, which the US broadly defined as 'any action or an act that holds back or prevents exports', are better disciplined under the GATT.

[2648] On the regulation of export restraints under the GATT, see P. C. Mavroidis, *Trade in Goods* (Oxford: Oxford University Press, 2007), 506 pp., at 16-17, 42-62, 84-85. The US interest in qualifying export restrictions as subsidies was that CVDs action could be undertaken against subsidized downstream imports instead of bringing a multilateral claim on the basis of, for instance, Article XI of the GATT. See discussion in *Note by the Secretariat, Subsidies and Countervailing Measures* (MTN.GNG/NG10/W/4, 28 April 1987), at 26-27.

[2649] Sykes, above n 2635, at 30.

[2650] In the words of Hudec:

> 'The question is whether some line can be drawn between the sort of competitive advantage created by things like subsidies, which have already been declared to be unclear, and the competitive advantage created by other differences in regulatory policy which arguably have the same effect, such as differences in environmental standards. Logically, the fairness concept underlying these characterisations does not offer a plausible distinction between one source of advantage and another. Anything that affects competition is potentially unfair. Happily, however, logic has not been the controlling variable so far. Governments seem to have recognized the practical need to limit the fairness concept at some point, even if the limitation makes no logical sense'.

bringing regulatory or exchange rate action under the ambit of the SCM Agreement, specific oversight preventing the risk of social or exchange dumping would be better intensified under other, more specialized international organizations or agreements.

1.1.2. Subsidization by foregoing revenue otherwise due

The inclusion of subsidization by negative fiscal action recognizes that a subsidy in its ordinary meaning is an acronym for a tax and that a negative tax is thus simply equivalent to a subsidy. Subsidization by positive and negative action generates similar effects. Although the inclusion of subsidization by negative fiscal action is therefore solid on economic grounds, articulating the appropriate benchmark for determining whether 'revenue is foregone' is not a straightforward exercise. This is particularly relevant for direct taxes (and social security charges) as no border tax adjustments are allowed to level the playing field at either the import or export side. Countries predominantly relying on direct taxes such as the US hold that the economic rationale underpinning this distinction between direct and indirect taxation is not convincing because direct taxes could very well be reflected in the final price. Again, the criticism holds that the measure's *nature* (i.e., indirect versus direct taxation) rather than its potential *effect* determines whether it is covered under the SCM Agreement and that the system is thus biased not only against high regulatory standards but also against direct taxes. What is more, it has been argued that the application of the relevant benchmark could even generate the result that measures having the same nature (i.e., direct taxes) and effect could, nonetheless, be disciplined differently. The 'but for'-test as well as the 'legitimately comparable income'-test refers to the domestic fiscal system as relevant benchmark. The concrete implications thereof are nicely illustrated by the US defense in the *US – FSC* case. The US argued that the European territorial tax system has the same economic effect as the FSC-exemption to its world wide tax system because both tax systems exempt foreign-source income of exporters. After all, whereas under a territorial tax system all foreign-source income is exempted from taxation, a worldwide tax system in principle taxes all sources of income and therefore needs an exemption to exclude foreign-source income of exporters. The US concluded that the 'WTO should not penalize a country using a world-wide system for incorporating elements of a territorial system in order to obtain comparable tax treatment for its exports'.[2651] Yet, the EC objected that the US was responsible for having chosen a general tax system that puts its exporters at a disadvantage, and this view was in essence followed by the Panel in *US – FSC*:

R. E. Hudec, *Essays on the Nature of International Trade Law* (London: Cameron May, 1999), 396 pp., at 263.

[2651] Panel Report, *US – FSC*, para 7.122.

> (T)he United States is free to maintain a world wide tax system, a territorial tax system or any other type of system it sees fit. This is not the business of the WTO. What it is not free to do is to establish a regime of direct taxation, provide an exemption from direct taxes specifically related to exports, and then claim that it is entitled to provide such an export subsidy because it is necessary to eliminate a disadvantage to exporters created by the US tax system itself. In our view, this is no different from imposing a corporate income tax of, say, 75 percent, and then arguing that a special tax rate of 25 percent for exporters is necessary because the generally applicable corporate tax rate in other Members is only 25 percent.[2652]

Hudec commented that this 'your own fault'-response by the Panel begs the following question: why should one government be allowed to create subsidy-like tax effects in one case but not in the other? In particular, why should the WTO reach a different result about a subsidy-like tax exemption for exporters depending on whether the country also exempts other foreign-source income? After all, the only difference between both systems is that the territorial tax systems exclude all foreign-source income, whereas the US FSC-exemption merely excludes foreign-source income of exporters. At first sight, there seems no economic logic available to explain this different stance.[2653,2654]

Considered at a general theoretical level, however, such a different outcome is inevitable given that the 'but for'-test as well as the 'legitimately comparable income'-test refer to the *domestic* legal order, which evidently varies among WTO Members. The example given by the Panel in *US – FSC* can serve as an illustration. Country A can apply a generally applicable corporate tax rate of 75 per cent with an exemption of 25 per cent for exporters, whereas country B might provide a generally applicable corporate tax rate of 25 per cent. Moreover, the domestic level is the only appropriate benchmark in the absence of a level playing field. Indeed, the WTO-adjudicating bodies cannot rely on an agreed international benchmark (e.g., a common corporate tax rate of 75 per cent), and the WTO itself is not a standard-setting organization but is essentially a negative integration model. In the words of the Panel, the choice of the tax system is 'not the business of the WTO' itself. So, the benchmark has to refer to the domestic legal regime of the country in question. As a consequence, Country B's

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2652 Panel Report, *US – FSC*, para 7.122.

2653 See R. E. Hudec, 'Industrial Subsidies: Tax Treatment of 'Foreign Sales Corporations', in E-U. Petersmann and M. A. Pollack (eds), *Transatlantic Economic Disputes – the EU, the US, and the WTO* (Oxford: Oxford University Press, 2003), 175–205, at 190.

2654 Caution should be exercised when considering the territorial tax systems as *ipso facto* SCM-compatible, given that the WTO did not yet have to decide on this. The US did not file a counterclaim. The Panel also emphasized that the 'WTO-consistency of other Members' tax systems, whether territorial or otherwise, is outside our terms of reference' (Panel Report, *US – FSC*, para 7.123). At first sight, it seems that, under both tests, the exemption of all foreign-source income under territorial tax systems would not constitute revenue otherwise due, given that the territorial tax system is the general rule and that the Appellate Body considered other foreign-source income as legitimately comparable income in *US – FSC (Article 21.5 – EC)*. Yet, future panels or the Appellate Body might also broaden the scope of legitimately comparable income when scrutinizing the exclusion of foreign-source income. Although unlikely in my view, they might consider income of firms earned at home and abroad as legitimately comparable income. See commentary on the case provided by *Worldtradelaw.net*.

tax system will probably fall outside the reach of the SCM disciplines, whereas the tax exemption provided by Country A might constitute a prohibited (export) subsidy even if the economic effect upon exporters is largely similar.[2655] It should be emphasized that the absence of an international benchmark generates no similar effect with regard to indirect taxes because differences between such taxes could be adjusted at the border in order for a level playing field to be created.

1.2. Benefit element: Effect of the subsidy

1.2.1. Market benchmark

The private market test relies on the domestic market as the primary benchmark for deciding whether a benefit is conferred. The aim is to determine whether the direct or indirect recipient is better off than 'but for' the financial contribution: could he have obtained such a financial contribution at similar terms on the private market? Countries A and B can provide the same goods/service at the same price, but whether or not this might confer a benefit depends on the prevailing market conditions in each country. In general, two implications of the private market benchmark as developed in the case law have been articulated.

First, the private market test neglects whether this private benchmark price also equals the socially optimal price. In the presence of market failures, the market price does not reflect all benefits (i.e., positive externalities) or costs (i.e., negative externalities) and the socially optimal price thus deviates from the market price. Hence, a subsidy would be present even if this only lowers the price to the socially optimal price and thus internalizes a positive externality. Conversely, a subsidy is *not* present in case the government fails to internalize negative externalities (i.e., socially optimal price is higher than the private market price). On this basis, Stiglitz' call to impose CVDs against US products because they do not bear the cost of environmental pollution seems legally flawed. He argued that:

> A subsidy means that a firm does not pay the full costs of production. Not paying the cost of damage to the environment is a subsidy, just as not paying the full costs of workers would be. In most of the developed countries of the world today, firms are paying the cost of pollution to the global environment, in the form of taxes imposed on coal, oil, and gas. But American firms are being subsidized—and massively so.[2656]

[2655] Notice that a general tax cut implemented by a regional government is treated as non-specific (Article 2.2 of the SCM Agreement). Conversely, a similar regional tax cut installed by the national government would be specific (Article 2.2 of the SCM Agreement; see also Rubini, above n 2644, at 173). Hence, Countries A and B can take an identical tax measure but whether this might be disciplined and countervailable depends on their governance structure. This flexibility given to regional governments is considered justified because it respects the federal structure of some WTO Members.

[2656] Stiglitz, above n 2639, at 2.

Yet, not paying for produced negative externalities is not considered a subsidy under the SCM Agreement. As elaborated above, low levels of regulatory standards as well as general low levels of taxation fall outside the scope of the subsidy definition.[2657,2658] Finding inspiration in Article 14 of the SCM Agreement, panels and the Appellate Body have correctly decided that the private market price forms the appropriate benchmark. The subsidy definition thus disregards the question on whether government interventions are corrective rather than distortive in nature.[2659] In the discussion on export credit support (see Part III), it was illustrated that governments effectively fulfilling their complementary role to the private financial market would precisely offer financial contributions at beneficial terms. Here again, it should be emphasized that the subsidy definition does not outlaw corrective subsidization *as such*. In my view, it seems more appropriate to introduce more flexibility on *corrective* subsidies under the applicable disciplines instead of excluding such interventions from the scope of the subsidy definition in the first place. This approach was exactly implemented by introducing 'green light' types of subsidization. Likewise, this partly explains the rationale

[2657] As explained above, the domestic market forms the benchmark for assessing whether revenue is foregone under a tax system.

[2658] See also J. Bhagwati and P. Mavroidis, 'Is action against US exports for failure to sign Kyoto Protocol legal?', 6:2 *World Trade Review* (2007), 299-310, at 302-303; S. Z. Bigdeli, 'Incentive Schemes to Promote Renewables and the WTO Law of Subsidies', in T. Cottier, O. Nartova, and S. Z. Bigdeli (eds), *International Trade Regulation and the Mitigation of Climate Change* (Cambridge: Cambridge University Press, 2009), 155-199, at 157-160; J. Pauwelyn, 'US Federal Climate Policy and Competitiveness Concerns: The Limits and Options of International Trade Law', *Working Paper – Duke University* (2007), 44 pp., at 14-15. However, Howse and Eliason agree with Stiglitz that CVDs could be imposed in response to a lack of undertaking action under the Kyoto Protocol. They suggest that the allowance to emit carbon constitutes the provision of a good (e.g., a right to emit carbon is given by the government) which confers a benefit, whereby an adjusted market price in a country that has installed an emission trading market (e.g., EC) is used as benchmark. However, their creative interpretation seems to be based on an overly broad reading of Articles 1.1(a)(1)(iii) and 14(d) of the SCM Agreement and of the Appellate Body's ruling in *US – Softwood Lumber IV*. Reviewing the same case, de Cendra disagreed that an allowance can be defined as a good under the SCM Agreement. Hufbauer et al also concluded that 'unlike a right to timber where timber itself is a good, a right to generate greenhouse gas emissions is not a right to a good because greenhouse gas emissions are not a good as the term is commonly used'. Moreover, Howse and Elisason also overlook that the Appellate Body was very reluctant to open the door to market prices in other countries. See R. Howse and A. Eliason, 'Domestic and International Strategies to Address Climate Change: An Overview of the WTO Legal Issues', in T. Cottier, O. Nartova, and S. Z. Bigdeli (eds), *International Trade Regulation and the Mitigation of Climate Change* (Cambridge: Cambridge University Press, 2009), 48-93, at 73-76; J. de Cendra, 'Can Emissions Trading Schemes be Coupled with Border Tax Adjustments? An Analysis vis-à-vis WTO Law', 15:2 *RECIEL* (2006), 131-145, at 137; G. C. Hufbauer, S. Charnovitz, and J. Kim, *Global Warming and the World Trading System* (Washington DC: Peterson Institute for International Economics, 2009), 166 pp., at 61-62.

[2659] Schwartz and Harper revealed a similar approach under the GATT system:

> 'A subsidy is treated in the GATT framework as a "distortion" of international trade,' that is, as creating a disparity between the actual costs incurred in producing a particular good and those which must be borne by the firm under- taking its production." In fact, however, much (perhaps all) government support can be defended as being a "correction" rather than a "distortion" of the market process. The need for correction is said to derive from the existence of "externalities" (…)'.

W. Schwartz and E. W. Harper, 'The Regulation of Subsidies Affecting International Trade', 70:5 *Michigan Law Review* (1972), 831-858, at 833.

for S&D treatment given to developing countries. Finally, it has been suggested that the specificity test could play a useful role to exclude corrective subsidies from subsidy disciplines and CVDs responses.[2660]

Second, scholars have underlined that the benefit analysis only detects whether the financial contribution (or income or price support) *an sich* is provided at better-than-market terms and hereby disregards the broader regulatory framework. Indeed, in case a firm receives a loan at below market rates, a benefit is conferred under the SCM Agreement without any consideration of the various taxes or regulatory burdens imposed upon the firm in question.[2661] Because the financial contribution is isolated in the benefit test, it is simply irrelevant whether or not it is provided to compensate, for instance, for overvalued exchange rates, higher environmental standards, or location in a disadvantaged region. To be precise, the only government-imposed burdens that can be compensated are indirect taxes or import duties since these can be adjusted at the border.[2662] By disregarding whether the benefit is not offset by other taxes or regulatory burdens, the subsidy definition fails, according to Sykes, to sort out the net impact of the government on the firm's competitive position. Although recognizing that such an exercise would be 'extraordinarily complicated and fraught with error', he concludes that 'to ignore the problem is to render the system unable to detect true subsidization of an industry except by chance'.[2663] Although he seemed to share this concern, Hudec rightly considered that an exercise to single out the net effect would simply be impossible.[2664] While largely neglected under the subsidy *definition*, this concern helps to explain why to some extent more flexibility was given to certain forms of subsidies. The 'green light' status of subsidies intended for implementing higher environmental standards or for firms to locate in disadvantaged regions was defended by the EC during the Uruguay Round precisely because it compensated for higher costs.[2665] This line of reasoning is thus

[2660] See below Part IV, Chapter 2, Section 2.1.1.

[2661] A. O. Sykes, 'Subsidies and Countervailing Measures', in P. F. J., Macrory, A. E. Appleton, and M. G., Plummer (eds), *The World Trade Organization: Legal, Economic and Political Analysis – Volume II* (Heidelberg: Springer Verlag, 2005), 83-107, at 86.

[2662] A legitimate concern of developing countries is that the limited scope for duty drawbacks works at their disadvantage (see below Part IV, Chapter 3, Section 3.2.2).

[2663] Sykes, above 2661, at 100. In Sykes' opinion, the specificity test can also not rescue the WTO approach because even general government measures will likely generate a non-neutral impact.

[2664] According to Hudec, '(t)here are many differences between business conditions found in one country and another (and) (w)e know that there is no way to measure the net balance of advantage produced by such differences'. See Hudec, above n 2650, at 263, 237-238. Somewhat along the same lines, see also A. Green, 'Trade Rules and Climate Change Subsidies', 5:3 *World Trade Review* (2006), 377-414, at 405.

[2665] Hence, the EC argued that such subsidies did not affect competition. *Submission by the European Community* (MTN.GNG/NG4/W/36, 2 February 1990). Yet, the conclusion that such subsidy does not affect competition is based on the unlikely assumption that the subsidy merely affected the location decision of the firm within the subsidizing member. See also below n 2680; A. O. Sykes, 'Second-Best Countervailing Duty Policy: A Critique on the Entitlement Approach', 21 *Law & Policy in International Business* (1990), 699-721, at 717.

based on what could be labelled the 'level playing field'-argument: by offsetting other taxes and regulatory burdens (or even market distortions), such subsidies would simply level the playing field and would therefore not distort competition.

Even if one accepts that the benefit analysis narrowly focalizes on the terms of the financial contribution, the test fails to single out those contributions that generate an impact on the recipient's competitive position. This relates to the criticism formulated by Grossman and Mavroidis on the benefit test developed in the case law, which will be discussed in the next section.

1.2.2. Distortive effect on competition

Grossman and Mavroidis have criticized the 'benefit'-definition developed in the case law for the reason that it does not discern those subsidies that effectively generate an effect on the market.[2666,2667] Because the SCM Agreement aims at protecting producer welfare,[2668] the definition of a subsidy must be one that 'helps to identify policies that inflict such harm'.[2669] Accordingly, a benefit is in these authors' view conferred when a *competitive* advantage is offered to firms vis-à-vis other firms. Hence, the benefit test should not simply look at whether the recipient is *generally* better off (e.g., in terms of wealth) than but for the financial contribution. Instead, it should examine whether its *competitive* position is improved compared to 'but for' the financial contribution. Behind their alternative approach seems to be the recognition that a precondition for causing harm to foreign producers is that domestic firms' output levels are increased as a result of a financial contribution[2670], which in turn

[2666] See G. M. Grossman and P. C. Mavroidis, 'US – Lead and Bismuth II, United States Imposition of Countervailing Duties on Certain Hot-Rolled and Bismuth Carbon Steel Products Originating in the United Kingdom: Here Today, Gone Tomorrow? Privatization and the Injury Caused by Non-Recurring Subsidies? (WT/DS138; DSR 2000:V, 2595; DSR 2000:VI, 5623)', in H. Horn and P. Mavroidis (eds), *The American Law Institute Reporters' Studies on WTO Case Law – Legal and Economic Analysis* (Cambridge: Cambridge University Press, 2007), 183-213; G. M. Grossman and P. C. Mavroidis, 'United States – Countervailing Measures Concerning Certain Products form the European Communities (WTO Doc. WT/DS212/AB/R; DSR 2003:I, 5; DSR 2003:I, 73): Recurring Misunderstanding of Non-Recurring Subsidies', in H. Horn and P. Mavroidis (eds), *The American Law Institute Reporters' Studies on WTO Case Law – Legal and Economic Analysis* (Cambridge: Cambridge University Press, 2007), 381-390; see also H. Horn and P. C. Mavroidis, 'United States – Preliminary Determinations with Respect to Certain Softwood Lumber from Canada (WT/DS236; DSR 2002:XI, 3597): What is a Subsidy?', in H. Horn and Petros M. (eds), *The American Law Institute Reporters' Studies on WTO Case Law – Legal and Economic Analysis* (Cambridge: Cambridge University Press, 2007), 523-549.

[2667] See also Sykes, above n 2635, at 34-34.

[2668] This conclusion is stated from the perspective of positive theory. Grossman and Mavroidis, 'Here Today, Gone Tomorrow?', above n 2666, at 198-199.

[2669] Grossman and Mavroidis, 'Here Today, Gone Tomorrow?', above n 2666, at 199-200.

[2670] A financial contribution could also prevent output levels from decreasing. Therefore, the formulation that output levels would be lower 'but for' the financial contribution is more accurate. Moreover, the fact that output would be higher is a necessary but (strictly speaking) not a sufficient condition in order for foreign firms to be hurt, because such increased output should also depress (or principally assumes that it directly or indirectly lowered their marginal costs (i.e., the cost of producing one extra unit of output).[2671,2672] Indeed, a profit-maximizing firm sets output decisions in such way that marginal costs, which are a function of production costs, equate marginal revenue. Put differently, a competitive advantage is present in case domestic firms' output level (marginal costs)[2673] would have been lower (higher) 'but for' the financial contribution.[2674]

Regarding recurring subsidies, which are ongoing government transfers, Grossman and Mavroidis illustrate that an effect on output is in most cases easily established.[2675] These recurring subsidies often take the form of subsidies for inputs (e.g., labor), which are variable costs, or output (i.e., production subsidies). Hence, such recurring subsidies induce firms to generate more output as they directly lower marginal costs.[2676] Somewhat more difficult to assess is the impact on output decisions of non-recurring subsidies, which are one-time financial contributions at below market prices. These usually come in the form of direct or potential direct transfers of funds (e.g., grants, loans, loan guarantees) at below market prices for the acquisition of fixed assets (e.g., technology, plant, equipment). A profit-maximizing firm will disregard the costs of such fixed assets in the short-run when deciding on production levels. In considering their (level of) acquisition, the firm will assess whether its discounted profits outweigh the private costs of financing (net-present value). If acquired, the firm's

suppress) the world price. See, for example, R. Diamond, 'A Search for Economic and Financial Principles in the Administration of United States Countervailing Duty Law', 21 *Law & Policy in International Business* (1990), 507-608, at 539. In this section, we assume that larger output also results in a fall of the world price and thus adopt the large country perspective.

[2671] The suggestion that the effect on the competitive position should be the focal point of the 'benefit' analysis somewhat resembles the plea of proponents of the so-called entitlement rationale in the 1980s (i.e., Goetz, Granet, Shwartz, and Diamond). These authors advocated that CVDs should only be imposed insofar and to the extent marginal costs are lowered as a result of a subsidy. An important difference seems to be that Grossman and Mavroidis more readily accept a subsidy initially affects the recipient's output decision (see below n 2680). See C. J. Goetz, L. Granet and W. F. Schwartz, 'The Meaning of 'Subsidy' and 'Injury' in the Countervailing Duty Law', 6 *International Review of Law and Economics* (1986), 17-32; R. Diamond, 'Economic Foundations of Countervailing Duty Law', 29 *Virginia Journal of International Law* (1989), 767-812; Diamond, above n 2670, at 507-608. See also A. O. Sykes, 'The Economics of "Injury" in Antidumping and Countervailing Duty Cases', in J. S. Bhandari and A. O. Sykes (eds), *Economic dimensions in international law – Comparative and empirical perspectives* (Cambridge: Cambridge University Press, 1997), 83-125, at 99.

[2672] Sykes illustrates that there could be circumstances were strictly speaking marginal costs are not reduced as a result of subsidization but were output levels have nonetheless increased. Most cases of higher output levels do result from a reduction in marginal costs.

[2673] This was the focus of the proponents of the entitlement theory (see above n 2671).

[2674] Horn and Mavroidis, above n 2666, at 533; Goetz, Granet, and Schwartz, above n 2671, at 23.

[2675] However, the exact impact on the marginal costs might be difficult to establish. See, for example, Diamond, above n 2671, at 788-791.

[2676] Grossman and Mavroidis, 'Here Today, Gone Tomorrow?', above n 2666, at 202-204; Diamond, above n 2671, at footnote 34, 788-801; Goetz, Granet, and Schwartz, above n 2671, at 23. According to Diamond, this holds unless the payment equals the additional costs to the firms of the behaviour necessary to qualify for the payment (e.g., per unit subsidy requires but also compensates the firm to locate in an area of higher transport costs). Diamond, above n 2671, at 788.

production function will change, generating a shift in its profit-maximizing output level.[2677] The firm will again maximize profits by setting marginal costs equal to marginal revenue and the investment cost made to acquire the asset is a fixed one and will thus be disregarded.[2678]
In discussing the effect of subsidization on the firm's initial investment decision, two types of non-recurring subsidies are distinguished by Grossman and Mavroidis. First, consider the impact of a non-recurring subsidy offered to help financing a fixed-scale investment. Here, a dichotomy decision is presented: undertake the investment in full or not at all (e.g., building a plant at minimum efficient scale). This will initially alter the firms' competitive position if 'one or more firms that would not have undertaken the project absent the subsidy decides differently in response to the government's contribution'.[2679,2680] If so, the subsidy would result in production at a larger scale or induce more firms to become active in the industry. This might cause a fall in prices, inflicting harm upon foreign firms. Second, consider the impact of a subsidy offered to help financing investment that may vary in size (e.g., capital equipment). By reducing the cost of financing, the subsidy would result in a larger scale of investment. This indirectly lowers marginal costs and thus induces more production.[2681] Again, the subsidy causes harm to foreign firms because output levels are boosted.

In sum, the 'benefit'-approach developed in the case law (and supported by Diamond[2682]) takes the *market value* as benchmark to determine the existence of subsidization: is a financial

[2677] Diamond, above n 2671, at 801, footnote 84.
[2678] Diamond, above n 2671, at 802.
[2679] Grossman and Mavroidis, 'Here Today, Gone Tomorrow?', above n 2666, at 205.
[2680] Compared to the proponents of the entitlement theory, Grossman and Mavroidis seem to be more inclined to agree that this condition will initially be fulfilled when the financial contribution is offered. Contrary to recurring subsidies for inputs and output, a non-recurring subsidy could according to the proponents of the entitlement theory (i.e., Diamond, Goetz, Granet, and Swartz) not only decrease but also increase marginal costs, in which case no harm would be caused to foreign producers as output levels would even be reduced. A firm will accept a subsidy which raises its marginal costs insofar the level of the subsidy compensates for its loss in profits resulting from lower output levels. Goetz et al have given the example of a subsidy inducing a firm to locate in an area with higher operating costs. Its competitive position would be negatively affected but acceptance of the subsidy is still rational as it compensates for those higher operating costs. If so, no CVDs should be imposed by importing countries. Diamond, above n 2670, at 538-539; Diamond, above n 2671, at 787-788; Goetz, Granet, and Schwartz, above n 2671, at 24. Yet, Sykes correctly specifies that this conclusion no longer holds if the plant with higher marginal costs (plant 2) does not substitute for another plant in a more efficient location (plant 1), but simply adds to existing capacity. Even if marginal costs in plant 2 would be higher than in plant 1, the total profit-maximizing output level (at firm or industry level) would be higher than absent the financial contribution. Hence, a marginal cost approach would require a determination of how the new plant has affected the investment or disinvestment not only of the subsidized firm but also of other firms in the subsidizing country. Sykes, above n 2665, at 717.
[2681] The larger the subsidy, the greater the level of investment that equates marginal costs to marginal revenue. Grossman and Mavroidis, 'Here Today, Gone Tomorrow?', above n 2666, at 206.
[2682] Diamond holds that there is no interpretative basis for supporting Grossman and Mavroidis' suggestion to take the effect of the financial contribution upon producers into account under the benefit element. Such effect of the subsidy is only assessed under the causation element which is part of the 'adverse effect'-test (in case of actionable subsidies) and injury test (in case of actionable subsidies and

contribution made at better-than-market terms? In contrast, the approach suggested by Mavroidis and Grossman looks at the financial contribution's impact on the *competitive position* to determine the existence of subsidization: does a financial contribution improve the competitive position of the recipient?

Both approaches have resulted in a different answer on the question whether privatization of a firm at arm's length and for fair market value extinguishes the continued existence of a benefit derived from a prior non-recurring financial contribution.[2683] In short, does privatization at fair market price extinguish benefits resulting from prior non-recurring subsidization? After briefly recapitulating the Appellate Body's response, we turn to the criticism by Grossman and Mavroidis. Next, we examine Grossman and Mavroidis' alternative regarding the allocation of the benefit of non-recurring subsidies. This is equally based on their different benefit-definition.

1.2.2.1. The impact of privatization on the benefit analysis

Benefits of non-recurring subsidies are often allocated over the average useful life of the acquired assets in the relevant industry.[2684] For instance, if the government has financed at favourable terms the acquisition of a machine with 'utility value' of ten years, the benefit of such subsidy under the 'useful life'-approach would be spread over ten years. The Appellate Body considered such 'useful life'-practice permissible under the SCM Agreement, so long as the presumption is not irrebuttable.[2685]

But is such allocation over the useful life interrupted by the firm's privatization at arm's length and for fair market value?[2686] The Appellate Body in *US – Countervailing Duties on Certain EC Products* answered this question affirmatively. Although it acknowledged that the *utility* value of the equipment acquired at subsidized terms does not extinguish because of privatization, it considered this element irrelevant under the 'benefit' analysis as this test looks at the *market* value: if a fair market value is paid at the moment of privatization, 'the

CVDs). R. Diamond, 'Privatization and the Definition of Subsidy: A Critical Study of Appellate Body Texturalism', 11:3 *Journal of International Economic Law* (2008), 1-30.

[2683] For definitions of 'at arm's length' and 'fair market value', see below n 2686.

[2684] The benefits of recurring subsidies are usually considered fully absorbed in the year of receipt.

[2685] Appellate Body Report, *US – Countervailing Measures on Certain EC Products*, para 84; Appellate Body Report, *US – Lead and Bismuth II*, para 62.

[2686] *At arm's length* means that privatization is 'negotiated between unrelated parties, each acting in their own interest, or between related parties such that the terms of the transaction are those that would exist if the transaction had been negotiated between unrelated parties'. The *fair market value* test examines whether the purchaser paid 'the full amount that the company or its assets (including the value of any subsidy benefits) were actually worth under the prevailing market conditions'. These are the definitions applied under US CVDs procedures, as cited by the Panel in *US – Countervailing Measures on Certain EC Products (Article 21.5 – EC)*, at footnote 313.

market value is redeemed', and the benefit thus in principle extinguishes.[2687] Relaxing its stance taken in *US – Lead and Bismuth II*, the Appellate Body decided that such a fair market price does not *necessarily* extinguish prior subsidization but only offers a *presumption* thereof.[2688]

Grossman and Mavroidis have firmly criticized the Appellate Body's reasoning that a fair market price could extinguish the continued benefit of past non-recurring subsidies.[2689] They hold that the change of ownership – at fair market price or not – simply has no bearing on the question of the continuation of benefit, at least if the 'benefit'-concept is understood correctly as an amelioration of its competitive position and not in terms of economic 'wealth' as the Appellate Body does. The price at which a firm acquires assets should be qualified as a 'sunk cost', which does not affect their future profit-maximizing output decisions inasmuch marginal costs are left unaffected.[2690] The enhanced competitive position resulting of the firm's prior subsidization is not affected by the price paid for the change in ownership. Grossman and Mavroidis draw a parallel with non-recurring subsidies paid directly to *private* firms.[2691] Ownership shares of private firms frequently transfer in the private capital market (by definition at a fair market price). Hence, would this common practice also extinguish (parts of) the benefit of the non-recurring subsidy in the Appellate Body's view, given that the new owner does not personally benefit (in wealth terms) from the subsidy? This rhetorical question illustrates that a mere change in ownership does simply *not affect* the ameliorated competitive position of the firm in question, and thus leaves the harm caused to foreign firms untouched. In their words, 'a change in ownership – at fair market prices or otherwise – has no bearing on competitive conditions in the world market (…)'.[2692]

A somewhat similar argument was advanced by the US before the Appellate Body in *US – Countervailing Measures on Certain EC Products* when stating that 'irrespective of the price at which the new owners acquire the state-owned enterprise, "the artificially enhanced competitiveness generated by the subsidies" will not be eliminated, as the firm will continue

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[2687] Appellate Body Report, *US – Countervailing Measures on Certain EC Products*, para 102.

[2688] Appellate Body Report, *US – Countervailing Measures on Certain EC Products*, paras 122-127.

[2689] Because the benefit element cannot be interpreted along the lines suggested by Grossman and Mavroidis, Diamond concurs with the Appellate Body's reasoning on the effect of privatization, even though he would seem to principally agree with Grossman and Mavroidis' criticism from a normative viewpoint (economic theory). Diamond, above n 2682, at 6-8, 21-26.

[2690] Grossman and Mavroidis, 'Recurring Misunderstanding of Non-Recurring Subsidies', above n 2666, at 386-388. As Diamond has explained, 'new owners will set production based on short term marginal cost. So long as the purchase price is a lump sum and is not a function of quantities which may vary in the future, such as sales or profit, marginal cost will be unaffected by the price new owners pay. Whether the new owners pay a freely determined market price for the firm or a price which is below the market of the firm is, therefore, irrelevant'. Diamond, above n 2671, at 809, footnote 105.

[2691] Palmeter is credited by Grossman and Mavroidis for articulating this parallel.

[2692] Grossman and Mavroidis, 'Here Today, Gone Tomorrow?', above n 2666, at 201.

to produce "at the same costs and in the same volumes"'.[2693] Yet, the Appellate Body rejected this argument that its costs and volume of production remain the same regardless of the sales price of privatization, 'since these costs include, as a necessary component, the cost of capital':

> For example, if a government makes a "financial contribution" that "benefit[s]" a state-owned enterprise, and then sells that enterprise for *less* than its fair market price, would this not normally result in a "better off" return for the private capital newly invested in that enterprise? Would that not suggest, as a consequence, that the under-priced enterprise may then attract more investment than it would have attracted otherwise, if the government had sold it for fair market price? Why would this government-induced additional investment not then reduce the enterprise's cost of raising capital (either by borrowing it from the bank or from, say, shareholders) and, ultimately, reduce the firm's overall costs of production?[2694]

In my view, the Appellate Body's reasoning seems to rightly qualify but not to refute the core of the argument articulated by the US and Grossman and Mavroidis. On the one hand, the claim that the level of the sales price has no bearing whatsoever on subsequent, profit-maximizing behaviour seems indeed too rigid as a *below* the market price could improve the firm's financial position and thus generate a reduction in the cost of raising capital. This could affect production costs and thus output decisions in the future.[2695] On the other hand, the core thesis that the artificially enhanced competitiveness generated by prior non-recurring subsidies will not be eliminated by a fair market price is not rejected at all by the Appellate Body's argumentation.[2696] The Appellate Body's response simply shows that an *additional* benefit regarding a firm's competitive position could be generated when privatization is done at *below* market prices.[2697] If, as proposed by Grossman and Mavroidis, the benefit analysis should consider whether the competitive position is altered as a result of privatization, the

[2693] Appellate Body Report, *US – Countervailing Measures on Certain EC Products*, para 103.
[2694] Appellate Body Report, *US – Countervailing Measures on Certain EC Products*, para 103.
[2695] A similar question is whether a non-recurring (and unexpected) grant would be considered as conferring a benefit under the marginal cost approach. It could indeed be argued that an untied grant may allow a firm to buy, for example, new equipment, hereby achieving a lower marginal cost. However, Diamond counters this argument as it 'assumes that the firm, prior to the receipt of the grant, was not efficiently using capital. If the firm was acting efficiently and a profitable investment in a new plant had been available, the firm would have made the investment even if the grant had not been received. If it would not have made such a investment, it will not use the funds received from the government for that purpose'. In his view, an untied and unexpected grant does therefore not affect output decisions. See Diamond, above n 2671, at 787. But Diamond's reasoning seems to overlook that an investment might become profitable precisely because the cost of financing is lowered as a result of the grant. Prior to subsidization, the profit-maximizing firm had to include the higher private cost of capital in its calculation on whether a project is profitable or not. If a below the market price allows a firm to make an extra investment, marginal costs are indirectly lowered and output levels are increased as a result. Nonetheless, in considering the effect of a reduction in the cost of financing resulting from subsidization, Diamond seems doubtful that it would often have an effect on the firm's competitive position. Diamond, above n 2671, at 806-807.
[2696] As illustrated above, the Appellate Body simply rejects this argument because the benefit analysis looks at the market price.
[2697] The US seemed to share this view as well: 'the fact that the private owner pays full market price for the enterprise indicates only that the private *owner* is not receiving a *new* subsidy'. Appellate Body Report, *US – Countervailing Measures on Certain EC Products*, para 99.

following propositions seem to hold. First, the continuing benefit of prior non-recurring subsidies is not eliminated as a result of the shift in ownership, regardless of whether a fair or lower price is paid (subsidy 1). Second, if a price *lower* than the market price is paid, an additional subsidy could be present as the lower cost of capital could further improve the competitive position of the privatized firm (subsidy 2).

In conclusion, under the present case law, there is a *presumption* that privatization at a fair market price extinguishes the continued benefit of prior non-recurring subsidies.[2698,2699] As accurately revealed by Grossman and Mavroidis, this case law could be criticized since a change of ownership – regardless of the actual price – does not affect the artificially generated competitive advantage. In fact, a sale at *below* market price could only generate an *additional* benefit. To be clear, it is sometimes suggested that the Appellate Body in *US – Countervailing Duties on Certain EC Products* has partly met this criticism of Grossman and Mavroidis by shifting from a *ir*rebuttable to a rebuttable presumption of the extension of continued benefit. But the somewhat peculiar relaxation adopted by the Appellate Body seems not to be related at all to the thesis articulated by Grossman and Mavroidis.[2700] Recapitulating the Appellate Body's central view as it still stands today, 'once a fair market price is paid for the equipment, its *market value* is redeemed, regardless of the utility the firm may derive from the equipment', and only this market value is considered relevant under the benefit analysis .[2701]

[2698] In order to implement the Dispute Settlement Body's recommendations in the *US – Countervailing Measures on Certain EC Products*, the US has drafted a new privatization methodology. This prescribes the 'baseline presumption' that non-recurring subsidies benefit the recipient over a period of time, usually the average useful life of the recipient's assets. These subsidies are therefore allocable over that period of time. The subsidy recipient can rebut this presumption by demonstrating that privatization, *inter alia*, occurred at arm's length and for fair market value. If demonstrated, 'the injured party can still prove the benefit was not extinguished by showing that broader market conditions were not present or were distorted by the government. To do so, the injured party must either demonstrate the absence of basic conditions for a properly functioning market or the existence of legal/fiscal incentives that distort terms of sale'. See Panel Report, *US – Countervailing Measures on Certain EC Products (Article 21.5 – EC)*, footnote 313. This new methodology was not *as such* challenged before the compliance Panel (footnote 206 and para 7.89).

[2699] The Panel in *US – Countervailing Measures on Certain EC Products (Article 21.5 – EC)* decided that the CVDs administration has to *determine* in a sunset review whether privatization has occurred at arm's length and for fair market value and cannot simply *assume* that this has been the case. The Panel found support in previous case law as well as in the text of Article 21.3 of the SCM Agreement. The most relevant practical reason for rejecting the assumption as being sufficient is that it is unclear how it would be treated under a potential future assessment review (as an assumption or a determination). See Panel Report, *US – Countervailing Measures on Certain EC Products (Article 21.5 – EC)*, paras 7.198-7.217.

[2700] Grossman and Mavroidis first articulated their viewpoint in a case note on *US – Lead and Bismuth II*. See Grossman and Mavroidis, 'Here Today, Gone Tomorrow?', above n 2666.

[2701] Appellate Body Report, *US – Countervailing Measures on Certain EC Products*, para 102 (emphasis in the original).

1.2.2.2. The allocation of non-recurring subsidies

The debate on the effect of privatization has illustrated that even if the actual holder is not better off in wealth terms, its competitive position could have improved as a result of prior subsidization. At the same time, Grossman and Mavroidis have argued that the recipient's competitive position does not always ameliorate when he is made better off in wealth terms. On the latter basis, they have criticized the practice in CVDs investigations (e.g., in the US[2702]) in which the benefit of non-recurring subsidies is – apart from the privatization issue – *ipso facto* allocated over the 'useful' life of assets in the relevant industry.[2703] Accordingly, they do not only take issue with the argument that privatization *as such* could break up continued benefit of past non-recurring subsidies, but also criticize that other elements relevant to this end are not considered. In their view, it should be regularly assessed whether the level of capital investment (physical or intangible) would remain higher than it would have been 'but for' the subsidy. For example, a low-interest loan might induce a firm to construct a plant that a profit-maximizing firm would not have undertaken given future expectations on the market. Such investment is thus considered 'marginal' (i.e., above and beyond what would have occurred without the subsidy), resulting in extra output (i.e., improved competitive position), which could be legitimately offset by CVDs. But what if in the following years consumer demand for the product in question would rise in such an exceptional way that it would become profitable for the subsidized firm to build the plant without the subsidy as well? In those circumstances, the initial subsidy is no longer causing extra output levels. As Grossman and Mavroidis have put it, 'a plant that was marginal at the time of its construction can become inframarginal in the light of subsequent events'.[2704] If so, the continued benefit has extinguished and no CVDs should be imposed anymore even if the useful life of the plant has not finished. Hence, an administrative review of CVDs should determine how the competitive position would look like during the review period if the subsidy had never occurred. If the CVDs procedure does not integrate such assessment, Article 21.1 of SCM Agreement is in Grossman and Mavroidis' opinion violated as this

[2702] In *US – Countervailing Measures on Certain EC Products*, the EC also agreed that the 'useful life'-approach is 'normal and accepted practice'. The Appellate Body has confirmed that the 'useful life'-method is permissible as long as the presumption of continued benefit is not irrebutable. See Appellate Body Report, *US – Countervailing Measures on Certain EC Products*, para 84. Diamond equally suggested that non-recurring subsidies should be countervailed over the 'useful life' of the assets as their effect on the marginal costs continues over that period. See Diamond, above n 2671, at 805.
[2703] This is still the case under current US CVDs practice. Grossman and Mavroidis, 'Here Today, Gone Tomorrow?', above n 2666, at 207-210; Grossman and Mavroidis, 'Recurring Misunderstanding of Non-Recurring Subsidies', above n 2666, at 398.
[2704] Grossman and Mavroidis, 'Here Today, Gone Tomorrow?', above n 2666, at 208.

provision prescribes that CVDs remain in force 'only as long as and to the extent necessary to counteract subsidization which is causing injury'.[2705]

However, two counterarguments could be formulated. From a practical viewpoint, their suggestion seems to be extremely demanding to implement correctly. Indeed, CVDs authorities should not only assess how the firm's initial competitive position (and those of other firms in the domestic market) was altered at the moment of subsidization[2706], but also how its competitive position would evolve 'but for' the subsidy over the entire useful life period. From a theoretical viewpoint, even if the firm would also make the investment in the non-subsidy scenario at a certain moment in time, its competitive position could still be better at that moment because it has made that investment at subsidized terms. After all, its financial position, and thus its cost of raising capital, might be better under the subsidy scenario.[2707] So, even if market conditions would have changed in such a way that the investment becomes profitable without the subsidy, it does not *ipso facto* mean that the initial subsidy would no longer generate extra output levels. Consequently, Article 21.1 of the SCM Agreement would not necessarily seem to be violated.

1.2.2.3. Concluding remarks

Reviewing the previous analysis, I concur with the initial point of the analysis drawn by Grossman and Mavroidis. The benefit analysis should ideally filter out those financial contributions that improve the competitive position of domestic firms. As the case of privatization demonstrates, even if the actual holder is *not made better off* in wealth terms, its competitive position could still be superior than but for the subsidy. Accordingly, I share their fundamental criticism on the case law. Indeed, privatization should not lead to the presumption that continued benefits of prior non-recurring subsidies are extinguished. On the other hand, the firm's competitive position could be assumed to have improved if demonstrated that a recipient is *made better off* in wealth terms. Recurring input and output subsidies directly lower marginal costs and non-recurring subsidies also might very well induce higher output levels. At minimum, the cost of capital would be lower as a result of

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[2705] Grossman and Mavroidis, 'Recurring Misunderstanding of Non-Recurring Subsidies', above n 2666, at 389.

[2706] The question on whether the subsidy indeed induced the extra investment (and to what extent) seems already extremely difficult to assess. Diamond already acknowledged that defining the counterfactual in the initial situation might be difficult. He did not suggest assessing the counterfactual again during the useful life period, as Grossman and Mavroidis propose. See Diamond, above n 2671, at 804. Sykes even considers it 'virtually impossible to determine how subsidies affect marginal costs'. Sykes, above n 2665, at 717.

[2707] This resembles the abovementioned Appellate Body's argumentation that a price below the market (at subsidized terms) reduces the price of raising capital and thus production costs. Again, it could be mentioned that Diamond seems to doubt that a reduction in the financing cost will often have an effect on the competitive position. Diamond, above n 2671, at 807.

non-recurring financial contributions, which could lead to an improvement in the firm's competitive position. Accordingly, in case of privatization at below market terms, an extra subsidy could potentially be revealed. When market conditions change over time so that an investment would have been made anyway, the benefit of non-recurring subsidies might not entirely vanish. Consequently, if a benefit in wealth terms is found, it could be reasonably assumed that the firm's competitive position has improved and that a benefit is conferred under Article 1.1(b) of the SCM Agreement.[2708] Exactly measuring the effect on marginal costs might be too demanding to implement in practice.[2709] Moreover, in case such subsidies would have no or only a marginal impact on firms' competitive position, they would in principle be subsequently filtered out under the 'adverse effects' (actionable subsidy case) or 'material injury' (CVDs action) thresholds.[2710] At least in theory[2711], only those subsidies *causing* such trade effects are indeed actionable or countervailable.[2712] Especially for non-recurring subsidies, it could be difficult to meet this threshold.[2713] Only for multilateral actions against prohibited subsidies could demonstration of the trade effect be circumvented as these are prohibited *as such*. To be sure, as the case law currently stands, the effect of subsidization on production levels could be largely neglected in CVDs investigations because the case law only mandates the establishment of a causal link between *subsidized imports* and injury instead of between subsidies and injury. In my view, this forms a deficiency in the standard set for demonstrating the causal relationship requirement, rather than one in the standard set for subsidy determination.

1.3. SPECIFICITY ELEMENT

In Part II, the discussion has illuminated that only 'specific' subsidies are challengeable and countervailable but that the concept of specificity, loosely defined in the SCM Agreement, is interpreted rather broadly in the case law.[2714] This implies that the hurdle of 'specificity' is rather easily passed before a panel or in a CVDs procedure. At first sight, such a wide interpretation could be welcomed given the mixed rationales underpinning the specificity test.

[2708] If no benefit in wealth terms is found (e.g., privatization at market price), it could potentially still be demonstrated that its competitive position has improved.
[2709] See also Green, above n 2664, at 406.
[2710] See also Diamond, above n 2682, at 19-21.
[2711] The pivotal question is how stringent the required nexus (causation standard) between subsidization and adverse effects and/or injury is interpreted.
[2712] Put otherwise, subsidies are neither actionable nor countervailable when they do not lead to higher levels of output and have no adverse volume or price effects on other WTO Members.
[2713] For certain types of subsidies, this was exactly circumvented with the presumption of 'serious prejudice' under Article 6.1 of the SCM Agreement, but this presumption has expired.
[2714] See above Part II, Chapter 3, Section 3.3.

First, a wide interpretation acknowledges that the economic rationale for the specificity test is not watertight. Consider, for example, the US crop insurance subsidies that were 'generally, available for most crops but (…) not generally available in respect of the entire agricultural sector in all areas' and, on that basis, were considered specific by the Panel in *US – Upland Cotton*. Put otherwise, the crop insurance scheme reached 'a sufficiently discrete segment of the United States economy'.[2715] Yet, should the Panel have concluded the opposite if such crop insurance subsidies were open to all *agricultural products* in all areas in the US? Even in that case, the assumption that there is no trade-distortive effect because the subsidy does not affect the domestic resource allocation is not fulfilled, given it would benefit the agricultural sector over the industrial sector. To be sure, the Panel might still have found that such a subsidy would be sufficiently specific under Article 2 of the SCM Agreement.[2716] But what if a subsidized insurance programme applied to all *US products* nationwide? Here, it could be questioned whether such a nationwide subsidy programme could effectively be implemented without *de jure* differentiating between products on the basis of their characteristics and/or *de facto* being more used by certain enterprises. Hence, the subsidy might very often turn out *de jure* or *de facto* specific and thus – again – affect resource allocation among domestic enterprises. In sum, the partly flawed economic rationale would not seem to support a narrow definition of specificity.

This brings us to the second rationale underpinning the specificity test, namely that it excludes general provisions by all governments, such as police, fire protection, education, or roads, from the SCM Agreement. This rationale would also not necessitate a narrow interpretation of specificity as this test would principally aim at excluding governments' provision of services/goods with public goods characteristics. Hereby, the question arises as to whether these goods/services could effectively be provided without *de facto* benefiting certain enterprises more than others, but only to a lesser extent given that the link with the beneficiary is more diffuse. For example, investing in higher or scientific education might benefit knowledge-intensive industries more than others.[2717] Yet, this would be not sufficiently specific for certain enterprises to pass the specificity test.[2718] Recall that, on the basis of Article 1.1(a)(iii) of the SCM Agreement, 'general infrastructure' would not even fulfil the subsidy definition. Except for providing goods/services with public goods

[2715] Panel Report, *US – Upland Cotton*, para 7.1151.
[2716] Sykes has indicated that such a subsidy to all agricultural production would be deemed non-specific under US CVDs law. See Sykes, above n 2635, at 32.
[2717] See A.O. Sykes, 'International trade: Trade remedies', in A.T. Guzman and A.O. Sykes (eds), *Research Handbook in International Economic Law* (Cheltenham: Edward Elgar, 2007), 62-112, at 103.
[2718] See also footnote 26 of the SCM Agreement. Although the green light status of Article 8 of the SCM Agreement has lapsed, this footnote 26 of the SCM Agreement illustrates that investing in fundamental research is not disciplined under the SCM Agreement.

characteristics, the specificity test might under certain strict conditions also serve as a threshold to exclude corrective government measures from subsidy disciplines or CVDs procedures. This will be explained in the next section.

2. DISCIPLINES ON SUBSIDIZATION BY DEVELOPED COUNTRIES

2.1. DISCIPLINES ON DOMESTIC SUBSIDIES

Already during the ITO negotiations in the 1940s, a bifurcation between disciplines on export subsidies and those on domestic subsidies was supported as countries acknowledged that domestic subsidies were less likely to distort trade and could play an important role in spurring industrialization. Because only the GATT entered into force, however, no substantive limitation on subsidization emerged. Two relevant instruments to react against foreign subsidization were foreseen, which could help safeguarding tariff negotiations: non-violation complaints could be formulated when subsidization nullified benefits of tariff concessions (exporting market) and CVDs could be imposed to safeguard bound tariff levels (home market). The inability of the original GATT framework to halt subsidy competition among countries to protect their exporters' interest in third countries offered the impetus to start negotiations on disciplining export subsidies in the OEEC and the GATT, leading to the 1960 Declaration. Because domestic subsidies could also adversely affect their producers' trading interests in foreign markets, the US started to push for substantive obligations on domestic subsidies during the Tokyo Round, which resulted in rather flexible disciplines for those countries that had signed the Subsidies Code. In essence, other signatories had accepted these limitations on subsidization in return for stronger disciplines on CVDs. The same dynamics also explained the further strengthening of the disciplines on both domestic subsidies and CVDs action in the Uruguay Round. At the same time, countries had become more open to strengthened subsidy disciplines because of the severe budgetary impact of subsidy competition in times of – and inflicted by – an economic downturn.

This somewhat simplified summary explains the presence of the existing disciplines on domestic subsidies for non-agricultural products (positive theory).[2719] Turning to a normative perspective, two lines of criticism have been formulated regarding these disciplines on developed countries set out in Part III of the SCM Agreement. First, since the expiration of the green light subsidies, these disciplines disregard whether subsidies serve a legitimate purpose by focalizing exclusively on their potential trade effect upon other Members. Second, Bagwell and Staiger have formulated a systemic criticism because existing subsidy disciplines would inhibit further tariff reductions.[2720]

[2719] For more extensive overview of the negotiating history, see above Part II, Chapter 1.

[2720] I use the word 'systemic' to refer to the interaction between disciplines on different government instruments.

2.1.1. Substantive considerations: Subsidies as legitimate policy tool

The provisions on domestic subsidies inscribed in the Subsidies Code clearly reflected a balancing exercise: it was explicitly stipulated that these were widely used as important instruments to promote social and economic policy objectives (some of which listed[2721]), but it was equally acknowledged that such subsidies could adversely affect the trading interests of other signatories.[2722] Yet, the disciplines on these domestic subsidies were largely ineffective. At the same time, one should not forget that, given that no subsidy definition was agreed upon, there was no restraint upon other governments to impose CVDs if those permissible subsidies caused material injury to their domestic industry.[2723]

Under rather strict conditions and limitations, three types of subsidies were given green light status under the original SCM Agreement: R&D subsidies, environmental subsidies, and regional support.[2724] Importantly, potential adverse effects caused upon trading partners by such subsidies could not be responded to under either the multilateral (dispute settlement) or the unilateral (CVDs) track. Only a very limited procedure before the SCM Committee could be launched when non-actionable subsidies caused 'serious' adverse effects.[2725]

Since the expiration of this class of subsidies as of 1 January 2000, only the trade effect upon other WTO Members is considered relevant to decide upon the WTO-conformity and countervailability of domestic subsidies. As the 2006 World Trade Report has put it, 'no reference is made to the need to balance the effects on trading partners with Members' interests in pursuing certain policy objectives'.[2726] The only exception applies to the S&D

[2721] This non-exhaustive list referred to: (i) elimination of disadvantages of specific regions; (ii) facilitation of restructuring of sectors; (iii) sustainment of employment; (iv) encouragement of R&D, especially in high-technology industries; (v) promotion of development in developing countries; and (vi) redeployment of industries to avoid congestion and environmental problems (Article 11:2 of the Subsidies Code).

[2722] Here, different types of adverse effects were distinguished. Next to injury to the domestic industry of another signatory and nullification or impairment, 'serious prejudice' to the industry of another signatory (Article 11:2 of the Subsidies Code) was also included.

[2723] This aspect seems sometimes insufficiently emphasized by proponents of the soft disciplines imposed upon domestic subsidies under the Subsidies Code. Green, for example, correctly observes that the wide scope for government subsidies under the Subsidies Code reflected a 'recognition that it was very difficult, if not impossible, to identify permissible subsidies and therefore states should have the ability to adopt them'. But there was no limitation on CVDs imposed upon such permissible subsidies as well. See Green, above n 2664, at 407-408.

[2724] Previous drafts of the SCM Agreement had listed more types of green light subsidies but the EC had agreed to the US demand to reduce this list in exchange for less demanding language under Article 6.1 of the SCM Agreement. See Stewart T.P. (ed), *The GATT Uruguay Round – A Negotiating History (1986–1992) – Volume 1* (Deventer: Kluwer, 1993), 1382 pp., at 911.

[2725] See above Part II, Chapter 5, Section 5.1.3.2. According to the World Trade Report 2006, this implied that the trade-distortive potential was taken into account, even with regard to non-actionable subsidies. The Report considered this similar to other provisions which require a WTO Member to use measures in the least trade-distortive way possible (e.g., Article 2.2. of the TBT Agreement). WTO Secretariat, *World Trade Report 2006 – Exploring the Links Between Subsidies, Trade and the WTO* (Geneva: WTO Publications, 2006), 223 pp., at 200.

[2726] World Trade Report 2006, above n 2725, at 201.

treatment for developing countries, since this is also partly inspired by the corrective role of subsidization. For developed countries, corrective subsidies are put on an equal footing with all other types of subsidies. Here, the focus is on the potential adverse effect upon other WTO Members (or more precisely, upon their *producers*[2727]), regardless of the objective pursued.

What is more, it at first glance appears that the current disciplines are even *de facto* biased against corrective subsidies. As explained above, corrective government interventions, at least if they are fiscal in nature, might precisely take the form of a 'subsidy' as defined under the SCM Agreement. Governments playing their *complementary* role to the private market make financial contributions at terms that are by definition not available on the private market.

Moreover, as acknowledged in the 2006 World Trade Report, a conflict between the targeting principle, which should be adhered to for effectively correcting market failures, and the SCM Agreement provisions seems to be present. First, the targeting principle might partly be at odds with the specificity element. As Sykes indicates, in case where a principled justification for a subsidy exist, this 'will likely arise narrowly and case-by-case', so that the intervention will be specific.[2728] Hence, some targeted corrective subsidies seem to rather easily pass the specificity threshold. For example, subsidies directly stimulating the development of climate-friendly goods will be specific under the SCM Agreement.[2729] Second, respecting the targeting principle might also generate larger trade effects. This would make corrective subsidies more vulnerable for actionable subsidy claims or CVDs actions. Indeed, as the 2006 World Trade Report observed:

> By targeting the assistance so that it is delivered to the target population, industry or firm, the welfare cost of the subsidy programme is lowered. But, in a sense, this principle goes against the grain of WTO Agreements which consider a subsidy a problem the more specific it is. This is because the more specific subsidies are, the greater the assistance that they will be able to provide to an industry or to a firm, with potentially a greater output and trade response. It is not the intention here to exaggerate this possible conflict, but only to highlight the careful balancing act that governments must perform to ensure that their pursuit of legitimate policy goals, with the use of subsidies, do not run counter to their obligations under international agreements.[2730]

[2727] Consumer welfare does not enter the picture at all. Recall that subsidization is welfare-improving for net-importing countries and foreign consumers.
[2728] According to Sykes, 'WTO law does nothing to address the question whether the ostensible "subsidy" addresses some legitimate problem. The specificity test, in particular, bears essentially no relationship to this question. Indeed, where a principled justification for a subsidy exists, it will likely arise narrowly and case-by-case, so that the policy response will often appear "specific"'. Sykes, above n 2661, at 101; Sykes, above n 2635, at 33.
[2729] As Green explains, 'not all subsidies that promote environmental concerns may be specific but some valuable ones are targeted'. Green, above n 2664 at 400-401, 405.
[2730] World Trade Report 2006, above n 2725, at 108.

Although the 2006 World Trade Report thus pointed to this potential conflict, it finally reached the conclusion that the SCM Agreement nonetheless leaves 'room for targeting subsidies, depending on the criteria governments use for targeting'.[2731] In this respect, the Report referred to Article 2.1(b) of the SCM Agreement as this provision stipulates that specificity does not exist if *objective criteria* or conditions are established.[2732] This is the case if criteria for receiving subsidies 'are neutral, do not favor certain enterprises over others, and economic in nature and horizontal in application, such as number of employees or size of enterprise'.[2733] Referring to this 'objective criteria'-exemption, the 2006 World Trade Report concluded that any subsidy with a particular policy objective strictly adhering to these conditions would be free of the risk of counteraction by other WTO Members.

Yet, this strong conclusion needs to be nuanced in a double way, though it might have some merit in the end. First, it certainly offers no solution in case the market failure is related to an industry or group of industries, in which case the conditions for receiving subsidies should be fine-tuned to this sector. Second, even if objective conditions are formulated and thus horizontal in application, those subsidies would still be labelled specific by virtue of Article 2.1(c) of the SCM Agreement if they are for instance *de facto* predominantly used by an industry or group of industries.[2734] Recall that the Panel in *US – Softwood Lumber IV* rejected that only subsidies *deliberately* limited to certain enterprises (intent test) are covered under *de facto* specificity because the specificity test is 'concerned with the distortion that is created by a subsidy'.[2735] Consider, for example, the case of R&D subsidies. Even if their allocation is based on genuine objective criteria, they might *de facto* predominantly benefit research-intensive industries, and thus *might* in the end be considered 'specific' under the SCM Agreement.[2736] In sum, the 'objective criteria'-exemption spelled out in Article 2.1(b) of the SCM Agreement does certainly not offer *carte blanche* to corrective subsidies targeted to the market failure. The scope offered by this exemption to bring the subsidy's objective back in through the backdoor of the 'specificity test' is not well defined. Clearly, by crafting a category of 'green light' subsidies, the negotiating Members showed their awareness that

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[2731] World Trade Report 2006, above n 2725, at 201.

[2732] Insofar the eligibility is automatic and such criteria and conditions are strictly adhered to as well as 'clearly spelled out in law, regulation, or other official document, so as to be capable of verification'. Article 2.1(b) of the SCM Agreement.

[2733] Article 2.1(b), footnote 2 of the SCM Agreement.

[2734] Or if they are *de facto* specific under one of the other factors of Article 2.1(c) of the SCM Agreement. It seems that the World Trade Report 2006 acknowledged this interpretation but did not draw the logical conclusion. See World Trade Report 2006, above n 2725, at 198, 202.

[2735] Panel Report, *US – Softwood Lumber IV*, para 7.116.

[2736] Likewise, Green gives the example of subsidies aimed at providing energy efficiency or emission reduction payments across all sectors. These appear to be non-specific but might finally be qualified as *de facto* specific if there are a few industries (i.e., large emitters) which disproportionally use these subsidies. Green, above n 2664, at 405.

corrective subsidies could very well be specific under Article 2 of the SCM Agreement but that these subsidies still (temporarily) deserved green light.[2737]

The difficulty to give substance to both the 'objective criteria'-exemption and the *de facto* specificity test seems to result from the different rationales underpinning the specificity test. On the one hand, the 'objective criteria'-exemption (Article 2.1(b) of the SCM Agreement) might implement the distinction between selective and functional government interventions whereby the former are generally considered more vulnerable to capture by private interests and thus less likely to effectively serve a legitimate objective. Such selective interventions might sometimes also be less targeted to the origin of the market failure.[2738] For example, subsidizing R&D across all sectors might in theory be more effective than subsidizing only high-tech sectors.[2739] Yet, if the essential purpose of the specificity test is to isolate those subsidies having the potential to distort trade levels, the ultimate question is rather whether subsidies are *de facto* specific, regardless of whether their allocation is based on objective criteria. This is established under Article 2.1(c) of the SCM Agreement and the Panel in *US – Softwood Lumber IV* also seemed to articulate this purpose.

In the following sections, it will be examined whether developed countries should be given more policy space to offer subsidies that serve a legitimate objective. Should the effect-based approach of the current disciplines on domestic subsidies be altered with respect to corrective subsidies? This discussion will be relevant to developing countries as well, insofar the reactivation of the green light status to some subsidies would further enlarge developing countries' policy space as currently defined under the S&D treatment provisions.

2.1.1.1. Research and development subsidies

In Part I, we reached the conclusion that knowledge spillovers generated by R&D investments justify subsidization as an instrument of industrial policy in competitive as well as imperfectly competitive markets.[2740]

In case knowledge spillovers are local in nature, a (national) welfare-maximizing country clearly has an incentive to subsidize R&D so as to internalize this spillover. Such local knowledge spillovers are important factors explaining the emergence of innovative 'clusters', whereby productivity improvements are generated (i.e., external economies of scale). Moreover, world welfare is boosted as well, given that the rest of the world likewise benefits

[2737] See Article 8.1(b) of the SCM Agreement.

[2738] This somewhat relates to the argument articulated by Sykes that the specificity test might be useful to target those subsidies more likely to be based on political-economy than on welfare motivations.

[2739] To be sure, the optimal strategy is to offer *de jure* specific subsidies if the market failure is sector-specific (see above n 2728, 2729).

[2740] See above Part I, Chapter 2, Section 2.3.

from a terms of trade improvement resulting from this rise in productivity.[2741] However, the new trade theory explained that countries benefit more when clusters are located in their territory, explaining their incentive to launch competitive subsidization in order to attract innovative clusters. Interestingly, Norman and Venables have shown that world welfare is maximized when countries are unrestricted in such competition.[2742] International disciplines restricting such subsidization would be world welfare-depressing since it would result in too many clusters, each operating at an inefficient low scale.[2743] Nonetheless, as illustrated by fierce rivalry in the semi-conductor industry,[2744] an activist trade policy carries the risk that local knowledge spillovers will turn out lower than expected. In case knowledge spillovers leak abroad (e.g., through trade or FDI), national governments will become less inclined to offer subsidies. When spillovers would be purely international in nature, a national welfare-maximizing government would have no incentive to offer subsidies even though world welfare would again be boosted.[2745]

Turning to R&D subsidies as a strategic instrument in oligopolistic markets, Bagwell and Staiger have demonstrated that R&D subsidies could be a somewhat more robust policy recommendation than export or output subsidies are, because they remain optimal under Cournot as well as Bertrand competition. World welfare would be boosted as well since output is sub-optimally low in oligopolistic markets. In case knowledge spillovers would be generated, *domestic* spillovers will increase the probability that national governments offer R&D subsidies in strategic settings and governments would still offer such subsidies when *international* spillovers are sufficiently high.

Translating this economic underpinning for R&D subsidies into legal policy flexibility faces two hurdles: the need for simplification and the risk of circumvention. First, the economic studies' specific assumptions upon which a case for R&D subsidies rest cannot be fully reflected in legal disciplines. Indeed, a certain level of simplification is needed for legal disciplines to be workable. Such simplification runs the risk of crafting policy space for support that is not welfare-improving. Yet, the justification for R&D subsidies seems to be

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[2741] Such a terms of trade benefit occurs when the R&D subsidy is offered by a large country. No welfare effects on third countries are present when such R&D subsidy is made by a small country.

[2742] V. D. Norman and A. J. Venables, 'Industrial Clusters: Equilibrium, Welfare and Policy', 71 *Economica* (2004), 543–558.

[2743] The limitation on subsidies has the effect of reducing clusters' size but likewise increases their number as it induces more countries to offer subsidies so as to attract clusters. Norman and Venables, above n 2742, at 551-552.

[2744] See, for example, the claims brought before the WTO by Korea against CVDs imposed on DRAMs by the US, the EC, and Japan.

[2745] Interestingly, it was suggested during the GATT period that no (countervailable) subsidy would be present if knowledge generated through R&D assistance was *not* restricted. The assumption is that other firms would easily catch-up since the knowledge is publically available. Likewise, it was suggested no subsidy would be present in case the knowledge would be restricted (e.g., by a patent) and in case the firm returned the full amount of the assistance. See *Note by the Secretariat, Subsidies and Countervailing Measures* (MTN.GNG/NG10/W/4, 28 April 1987), at 24-25.

sufficiently general to temper this concern. Second, the major counterargument articulated against the re-activation of the green light status for R&D subsidies holds that money is fungible.[2746] Hence, countries might label subsidies serving other purposes as 'R&D subsidies' so as to circumvent more stringent disciplines on such subsidies. Here, specific conditions to qualify as R&D subsidies combined with a strong notification procedure might partly give in to this objection. Moreover, alternative conclusions derived from both hurdles, namely to offer *no* extra policy space for R&D subsidies or to impose *no* substantive policy constraints on any subsidization (as Sykes seems to suggest) seem inferior anyway.

In my view, the reinstallation of the green light status for R&D subsidies would therefore be justified. Before its expiration, Article 8.2(a) of the SCM Agreement offered rather extensive leeway for such subsidization. Hereby, a distinction was made between different types of R&D subsidies. First, it was emphasized that support for *fundamental research* independently conducted by higher education or research establishments was not disciplined under the SCM Agreement because the generated knowledge was not linked to industrial or commercial objectives.[2747] In contrast, support for R&D activities by firms or by higher education establishments on a contract basis was allowed upon the fulfillment of specific conditions. *Industrial research*, which aimed at the discovery of new knowledge,[2748] could be supported up to 75 per cent of its overall cost, whereas the next step of *pre-competitive development activity*,[2749] could be supported up to 50 per cent. Moreover, only certain types of costs, which are listed in Article 8.2(a) of the SCM Agreement, could be covered.[2750] To temper the concern of circumvention and to ensure that support is a deliberative choice, the stipulated notification requirements could be strengthened if the green light status would be re-installed. The weak spot of the notification procedure was that no substantive legal consequences were attached to a notification failure.[2751]

Since the large majority of R&D investments are made in developed countries, it comes as no surprise that not all developing countries are in favour of re-installing this category of green light subsidies in its current form. India, for instance, has argued that:

[2746] See *Submission by the United States* (MTN.GNG/NG10/W/29, 22 November 1989); Sykes, above n 2635, at 34.

[2747] Indeed, such support would rather be disciplined under the GATS. Under the SCM Agreement, the provision of services should benefit a specific industry in order to be disciplined (Articles 1 and 2 of the SCM Agreement). Hence, such support remains exempted from the SCM Agreement after the expiration of the green light status of R&D subsidies.

[2748] It should have the objective that such knowledge may be useful in developing new products, processes or services or in generating significant improvements to existing products, processes or services (footnote 28 tof the SCM Agreement.

[2749] See footnote 29 of the SCM Agreement.

[2750] It refers to costs of personnel, instruments, consultancy, overhead, or other running costs.

[2751] See above Part II, Chapter 4, Section 4.3.

> (…) the developed countries created a safe harbour for a substantial part of the activities on which the competitive strength of their firms rely. While this provision may have benefited developing countries in a few cases, rare as they may have been, it would not allow them exemption from countervailing duty action in case assistance were to be provided for the acquisition of technology, which is essential for developing countries.[2752]

Indeed, subsidies offered to acquire foreign technology ('inside-the-frontier innovation') differ from traditional R&D investments aiming at inventing new products and higher quality variants ('outside-the-frontier' innovation) for which the Article 8.2 carve-out was created.[2753] Although developing countries benefit from certain S&D treatment on subsidization to acquire this kind of technology, such subsidies are not shielded from potential CVDs action by trading partners. Still, they could also benefit from foreign R&D subsidies by developed countries, not only on the basis of a terms of trade improvement but also in case such spillovers flow abroad through for instance trade or FDI. On the other hand, one might be tempted to argue that developing countries could benefit from the extinction of the green light status for R&D subsidies. After all, stringent limitations on R&D (and other) subsidies imposed on developed countries might make it more likely that developing countries could capture innovative clusters precisely because they benefit from S&D treatment on domestic (and export) subsidies and would never win a competitive subsidy war. But again, potential CVDs action is not foreclosed and the pitfalls of an activist trade policy combined with their limited resources might warrant that such competitive subsidization is not an appropriate strategy for developing countries. Moreover, as Rodriguez-Clare underscored, there is no guarantee that local production of high-tech goods will generate the same clustering benefits. Even if it does generate such effects, developed countries will have probably reaped these clustering benefits already, which will have resulted in low international prices. Yet, the pitfalls of an activist trade policy do not imply that developing countries should not support R&D investments. After all, such support would ameliorate their capacity to absorb foreign innovations. Here, Rodriguez-Clare suggests the provision of R&D subsidies to stimulate clustering in those sectors in which developing countries have revealed their comparative advantage.[2754] Overall, the concerns raised by developing countries should not avert the re-installation of the green light status of R&D subsidies.

Under the current disciplines, R&D subsidies of developed countries would in principle be actionable and countervailable if causing adverse effects to the interest of other Members or material injury to their domestic industry, respectively. Only the 'objective criteria'-exemption under the specificity test might foreclose such trade effect test (Article 2.1(b) of

[2752] *Intervention by India on the Submission by the United States on Special and Differential Treatment and the Subsidies Agreement* (TN/RL/W/68, 11 March 2003).
[2753] See also above Part I, Chapter 2, Section 2.4.2.1.
[2754] See above Part I, Chapter 2, Section 2.4.2.2.2; see also below Part IV, Chapter 3, Section 3.2.2.

the SCM Agreement). Providing R&D support exclusively to technology-intensive industries would certainly be specific (i.e., selective intervention). In contrast, subsidizing R&D support directly and regardless of the sector might be superior in economic terms because it is more targeted and less prone to be captured by private interests, but such a functional intervention is at the same time also harder to implement in practice. In legal terms, this support might be deemed non-specific if effectively based on objective criteria, with the caveat that it could still be qualified as specific if *de facto* predominantly used by an industry or group of industries (e.g., technology-intensive industries).

2.1.1.2. Environmental subsidies

As introduced in Part I, the 2009 WTO – UNEP Report has grouped governments' interventions responding to the challenge of climate change into three broad categories: technical requirements to promote the use of climate-friendly goods and technologies, support for the development and deployment of such goods and technologies, and mechanisms to internalize the cost of greenhouse gas emissions (i.e., carbon/energy taxes and emission trading schemes).[2755] The policy constraints imposed upon each of these interventions under the SCM Agreement are assessed in this section.

2.1.1.2.1. Technical requirements

As point of departure, remind that *not* implementing the 'polluter pays' principle does not qualify as a subsidy under the SCM Agreement. This means that the failure to honour this principle by setting low regulatory standards cannot be countervailed by other WTO Members.[2756] Hence, countries are free under the SCM Agreement to adopt a low level of regulatory environmental standards. When they develop such non-fiscal measures, they could even exempt some specific industries from such requirements. At the same time, if a country does introduce more stringent environmental requirements, financial or fiscal compensation to its firms for their implementation would actually be disciplined under the SCM Agreement. Until 2000, such assistance was under certain conditions exempted. Indeed, green light was given to 'assistance to promote adaptation of existing facilities to new environmental requirements imposed by law and/or regulations which result in greater constraints and financial burden on firms' (Article 8.2(c) of the SCM Agreement). Still, such assistance had to limited to a one-time non-recurring subsidy covering at most 20 per cent of the cost of adaptation and had to be available to all firms which could adopt the new equipment and/or

[2755] WTO – UNEP Report, *Trade and Climate Change* (Geneva: WTO Publications, 2009), 166 pp..
[2756] See above n 2658.

production processes.[2757] Sykes considered this green light status as problematic precisely because it conflicts with the 'polluter pays' principle.[2758] Firms simply have to bear their pollution cost and should not be subsidized for not-polluting. Yet, this argument fails to recognize that competitiveness or carbon leakage concerns might inhibit governments to take any action at all so as to implement this 'polluter pays' principle . Under the carve-out, this principle was at least partly honoured because only 20 per cent of the costs could be recovered without risk of trade action by other WTO Members. One should not forget that individual governments' incentive is already too low to correct market failures generating international spillovers such as climate change. Therefore, I agree with Hufauer et al that the reinstallation of this green light category should be advised.[2759]

At the same time, the extinction of its green light status does not mean that such subsidies would actually be outlawed under the SCM Agreement.[2760] If based on objective criteria and *de facto* non-specific, it would not even be disciplined under the SCM Agreement. Yet, the fact that drafters installed the carve-out revealed their awareness that such regulatory standards (and thus also compensation for their implementation) could very well be industry-specific.[2761] Even in that case, it would only be actionable or countervailable if causing the required level of adverse trade effects.[2762] On the other hand, financial or fiscal assistance contingent upon exportation would be prohibited. Border tax adjustments compensating exporters for adaptation to higher environmental standards is certainly not allowed and would constitute a prohibited export subsidy. But again, simply exempting export-competing industries from stringent regulatory requirements would not be covered under the SCM Agreement.

Notice in concluding that the Agreement on Agriculture situates 'payments under environmental programmes' in the green box. Here, the payment should only be limited to the extra cost involved in complying with the government programme.[2763] Since the

[2757] Regarding the other conditions, see Article 8.2(c) of the SCM Agreement.
[2758] Sykes, above n 2635, at 34.
[2759] Hufbauer, Charnovitz, and Kim, above n 2658, at 110.
[2760] Bigdeli suggests that a benefit under the SCM Agreement might not be present if a regulatory burden on entities for environmental objectives would be compensated in one regulatory package by financial or fiscal measures. Overall, it is highly questionable whether the regulatory burden would be considered in assessing the benefit of the financial contribution (see above Part IV, Chapter 1, Section 1.2.1). As Bigdeli acknowledges as well, this might not fit the logic of the SCM Agreement. Article 8.2(c) of the SCM Agreement was exactly inscribed to give green light to a well-defined level of such governmental compensation. On the other hand, the example given by Bigdeli (i.e., free allowance of emission permits under cap-and-trade schemes) might indeed be a very limited exception to this general rule because of the intrinsic link between the financial contribution and the obligation (see below n 2808). See Bigdeli, above n 2658, at 162-163.
[2761] Mavroidis et al seem to conclude that the 'polluter pays' principle is forced upon WTO Members. See Mavroidis, Messerlin, and Wauters, above n 2636, at 312.
[2762] For challenging a non-recurring subsidy up to 20 per cent of the regulatory cost, this threshold might not be easy to pass.
[2763] Annex 2, para 12 of the Agreement on Agriculture.

expiration of the peace clause, such payments could in theory also be challenged as an actionable subsidy under the SCM Agreement. Likewise, they are not shielded from potential CVDs action.

2.1.1.2.2. Support for climate-friendly goods

Governments have developed financial and fiscal mechanisms to promote the development and deployment of climate-friendly goods and technologies (e.g., solar panels, wind turbines). Next to the positive environment externality generated by such goods and technologies,[2764] the WTO – UNEP Report lists a number of other market failures such as positive R&D externalities that would legitimize governmental fiscal or financial support.[2765] These measures likely qualify as specific subsidies under the SCM Agreement and would thus be vulnerable for CVDs action and actionable subsidy claims if demonstrated that they cause the required level of adverse trade effects.[2766] To counter such a response by trading partners, should a green box in the SCM Agreement be created to carve out such subsidies?[2767] Bigdeli opposes such a carve-out for renewable energy product subsidies. He holds that, if demonstrated that they cause adverse effects, this would mean that such subsidies are tipping the balance against more efficient foreign renewable energy producers. Taking away the adverse effects of such distortive renewable energy subsidies would benefit renewable energy trade and environmental protection.[2768] On the other hand, Green advocates the inclusion in the SCM Agreement of an explicit environmental exception along the lines of Article XX of GATT.[2769] This would provide policy space for subsidies for environmental protection and, at the same time, permit the WTO to discipline these actions for arbitrariness or discrimination.[2770] Adopting a middle course, I would rather suggest that the re-installation of the R&D subsidy carve-out with a strengthened notification procedure might go along way to

[2764] This positive externality *an sich* might also be internalized by tackling the negative externality of pollution through regulation or taxation. See also Bigdeli, above n 2658, at 155.
[2765] WTO – UNEP Report, above n 2755, at 110-111.
[2766] For a more in-depth analysis, see Bigdeli, above n 2658, at 163-182. See also G. N. Horlick, 'The WTO and Climate Change 'Incentives'', in T. Cottier, O. Nartova, and S. Z. Bigdeli (eds), *International Trade Regulation and the Mitigation of Climate Change* (Cambridge: Cambridge University Press, 2009), 193-196, at 194.
[2767] Howse and Eliason propose that negotiations should address 'the task of identifying a set of 'green box' renewable energy subsidies that Members agree to refrain from challenging, on account of consensus as to their positive environmental effects'. Howse and Eliason, above n 2658, at 90.
[2768] Bigdeli, above n 2658, at 189.
[2769] Even though no panel or Appellate Body has explicitly expressed its view on this question, most authors correctly hold that Article XX of the GATT is not available to justify a violation of the SCM Agreement. See, for example, B. J. Condon, 'Climate Change and Unresolved Issues in WTO Law', 12:4 *Journal of International Economic Law* (2009), 895-926; Horlick, above n 2766, at 194.
[2770] The re-inclusion of the green light status to environmental subsidies would certainly be insufficient in his view. Green, above n 2664, at 408-409.

meet the goal of spurring the development of climate-friendly goods.[2771] Such government interventions would not only be defensible on the basis of positive externalities generated by increased production, which *an sich* could be tackled in a more efficient way than by simply subsidizing domestic producers.[2772] Indeed, they would in addition be justified on the basis of the clear presence of R&D externalities in these sectors, which imply that production and trade levels are sub-optimal low under market conditions.[2773]

Instead of focusing on the supply side, governments might subsidize consumers (e.g. tax credits for installing solar panels). This would likewise boost investments in environmentally-friendly goods and could benefit foreign producers if implemented in a non-discriminatory manner.[2774] Such non-discriminatory subsidies offered to consumers would not be constrained under the SCM Agreement. Indeed, this subsidy would not be specific to certain enterprises (Article 2 of the SCM Agreement)[2775] and would not cause adverse effects upon other WTO Members as their producers might even benefit from consumer subsidies.[2776] Because part of the benefit of such consumer subsidies might flow abroad in the form of increased imports, domestic producers would rather put pressure upon their government to exclude foreign producers from such subsidy schemes. Yet, such an amendment would

[2771] Hufbauer et al have also suggested the installation of a peace clause for some climate-related domestic subsidies (such as R&D subsidies on alternative energy). Yet, the added value of their proposal seems limited as their suggested subsidy peace clause provision does in their view not cover subsidies that are specific under Article 2 of the SCM Agreement but would offer 'more legal certainty that generally available climate subsidies would not be challenged in WTO dispute settlement'. Hufbauer, Charnovitz, and Kim, above n 2658, at 109.

[2772] See above n 2764. Non-discriminatory consumer subsidies might also be more efficient to internalize the positive externality on the environment because goods will be sourced from the most efficient producer.

[2773] The Copenhagen Consensus Center asked an expert panel of leading economists to rank different policy responses to halt global warming. A very substantive increase in R&D for non-carbon energy was ranked as first-best. According to Lomborg, 'every dollar spent on R&D could avert 11 dollars worth of climate damage'. See L. Lane, J. Brickel, I. Galiana, C. Green, and V. Bosetti, *Advice for Policymakers* (Copenhagen: Copenhagen Consensus Center, 2009), 45 pp.; B. Lomborg, 'Technology, Not Talks Will Save the Planet', *IMF Finance & Development* (August 2009), 13-14.

[2774] See also OECD, 'Sustainable Manufacturing and Eco-innovation: Towards a Green Economy', *OECD Observer – Policy Brief* (June 2009), 7 pp., at 7.

[2775] This argument might be formulated in two ways. If the direct recipient would be the focus of the specificity test, such a subsidy is not specific because it would be available to all users (i.e., consumers) and not limited to certain enterprises. Conversely, if the focus of the specificity test would be on the ultimate beneficiary (e.g., solar panel producers), it would also not be specific to an industry 'within the jurisdiction of the granting authority' (Article 2.1 of the SCM Agreement) given that foreign producers could likewise benefit. The World Trade Report 2006 even more broadly considered that Article 2 of the SCM Agreement and other provisions in the SCM Agreement referring to producers of subsidized products imply that transfers to consumers 'may not be covered' by the SCM Agreement. World Trade Report 2006, above n 2725, at 54.

[2776] See also Howse and Eliason, above n 2658, at 88, 89.

plainly violate Article III of the GATT and be less efficient in economic terms as it discriminates against more efficient foreign producers.[2777]

Further, the WTO – UNEP Report points to the need for government interventions to spur R&D investments in the agricultural sector.[2778] In this respect, the Report refers to the policy space given under the green box for such support, which indeed lists support for 'research, including general research, research in connection with environmental programmes, and research relating to particular products'.[2779] Strictly speaking, the WTO – UNEP report hereby overlooks that such support could still be actionable and countervailable under the SCM Agreement, even though substantiating these actions would likely fail given that such green box R&D support under the Agreement on Agriculture could not involve direct payments to producers or processors.[2780]

Without going into detail, notice that subsidies stimulating the production of biofuels (i.e., ethanol or biodiesel) are likewise actionable and countervailable on the basis of the SCM Agreement.[2781] Insofar such support would qualify as support for agricultural products, it would in addition be disciplined under the Agreement on Agriculture. It has been advanced that the majority of such existing support measures would then fall in the 'amber box', in which case both the EC and US would surpass their commitment levels.[2782]

2.1.1.2.3. Government interventions internalizing the cost of greenhouse gas emissions

Governments have introduced price and market mechanisms to internalize the environmental costs of greenhouse gas emissions, a negative externality that is international in nature. Two mechanisms are hereby distinguished: carbon/energy taxes and cap-and-trade systems. Yet, if the 'polluter pays' principle is under such mechanisms (partly) introduced in some countries but not in others,[2783] this might hamper the competitiveness of subjected producers and could equally undermine the effectiveness of environmental protection as those producers might

[2777] For example, European producers have advocated limiting consumer subsidies for the installation of solar panels because such non-discriminatory subsidies boosted the imports of Chinese solar panels. See 'Chinese Solar Firm Revises Price Remark', *New York Times* (27 August 2009).
[2778] WTO – UNEP Report, above n 2755, at 88, 115.
[2779] Annex 2, para 2(a) of the Agreement on Agriculture.
[2780] Such support would also have to fulfil the general conditions (Annex 2, para 1 of the Agreement on Agriculture).
[2781] For instance, the EC has recently imposed CVDs against biodiesel imports from the US. See *Council Regulation (EC) No 598/2009 of 7 July 2009 imposing a definitive countervailing duty and collecting definitively the provisional duty imposed on imports of biodiesel originating in the United States of America, (2009) OJ L/179*.
[2782] Bigdeli, above n 2658, at 172-173.
[2783] The optimal solution would be to cooperate internationally to correct this international negative externality.

simply choose to relocate to countries with weaker environmental policies ('carbon leakage').[2784] This initiates the question whether governments could alleviate both concerns by adjusting the costs imposed under such mechanisms at both the import and the export side. Because our focus is on subsidy disciplines, we merely examine the available policy space for border tax adjustments (BTAs) at the exporting side.[2785] Moreover, regarding cap-and-trade systems, it is also open to discussion whether governments could respond to both concerns by allocating emission permits for free.[2786]

2.1.1.2.3.1. Border tax adjustment on carbon tax

In line with the GATT regime, the SCM Agreement incorporates the destination principle with respect to indirect taxes and the origin principle with respect to direct taxes (and social security charges). Hence, border tax adjustments (BTAs) at the export side are allowed for indirect taxes, which are imposed directly or indirectly on products, but not on direct taxes because these are deemed to be imposed upon the producer. However, are adjustments at the export side also permissible for taxes on inputs (e.g., energy) that are used in the production process but which are not incorporated in the final product?

In the 1970 GATT Working Party Report on Border Tax Adjustments, GATT Contracting Parties already inscribed their divergent views on whether such *tax occultes* (hidden taxes) could be rebated and noted that it appeared that such adjustment 'was not normally made' except in countries having a cascade tax.[2787] Item (h) of the Illustrative List attached to the Subsidies Code implemented the destination principle with regard to 'prior-stage cumulative indirect taxes' (PSCI taxes) such as cascade taxes. This item explicitly confined rebates to those taxes on 'inputs physically incorporated'. Most commentators therefore concluded that energy taxes not physically incorporated in the end product could not be rebated under the Subsidies Code.[2788,2789] Nonetheless, upon demand of India, the scope for rebates under item

[2784] WTO – UNEP Report, above n 2755, at 98; G. Van Calster, *International & EU Trade Law – The Environmental Challenge* (London: Cameron May, 2000), 564 pp., at 421.

[2785] Recall that a symmetric application at both sides is not mandated under the WTO. From an economic perspective, Mattoo et al have demonstrated that if BTAs would be imposed at the import side the appropriate policy is to implement it in a symmetric way and thus also make adjustments at the export side, even though the optimal policy from a purely trade perspective would be to have no scope for carbon-based BTAs. See A. Mattoo, A. Subramanian, D. van der Mensbrugghe, and J. He, 'Reconciling Climate Change and Trade Policy', *World Bank Policy Research Working Paper* No. 5123 (November 2009), 44 pp.

[2786] This is implemented under the Australian cap-and-trade system.

[2787] See also *Note by the Secretariat, Taxes and Charges for Environmental Purposes – Border Tax Adjustment* (WT/CTE/W/47, 2 May 1997).

[2788] Reference was also made to Article VI:4 and Ad Note Article XVI of the GATT, which refer to adjustments made with regard to duties or taxes 'borne by the like product'. See G. C. Hufbauer, J. E. Shelton, *Subsidies in International Trade* (Washington DC: Institute for International Economics, 1984), 283 pp., at 52-53. G. C. Hufbauer, *Fundamental Tax Reform and Border Tax Adjustments*

(h) was broadened in the SCM Agreement to '*energy*, fuels and oil used in the production process and catalysts which are consumed in the course of their use to obtain the exported product'.[2790] At the same time, US trade officials claimed that this amendment was not intended to fundamentally expand the right for BTAs on energy taxes for developed countries and emphasized that other developed countries shared their view.[2791] So, are such BTAs on energy/carbon taxes authorized under the SCM Agreement?

First of all, item (h) of the Illustrative List, dealing with PSCI taxes, does certainly not significantly expand the scope for such rebates. To be sure, this interpretation does not derived from the view expressed by the US as little value should be accorded to such unilateral interpretation.[2792] Instead, as explained by several scholars, energy/carbon taxes generally are single-stage taxes instead of multi-stage taxes and thus do not qualify as PSCI taxes that would be covered under item (h).[2793] Certainly, energy taxes could become such PSCI tax when collected as part of a cascade system but such a system is no longer in place in developed countries and is likewise progressively abandoned in developing countries.[2794] According to some scholars, however, the limited scope of item (h) should not mean that BTAs on energy taxes are outlawed in practice. After all, BTAs on energy taxes might still be saved under the residual category of 'indirect taxes' in respect of the production and

(Washington DC: Institute for International Economics, January 1996), 89 pp., at 49; Schlagenhof, above n 2636, at 143.

2789 In case energy taxes are physically incorporated in the final product (e.g. electrolysis), adjustment is considered allowed and not disputed. P. Demaret and R. Stewardson, 'Border Tax Adjustments under GATT and EC Law and General Implications for Environmental Taxes', 28:4 *Journal of World Trade* (1994), 5-64, at 22-23. Likewise, a tax on domestically produced fossil fuels could be rebated upon exportation under item (g) of the Illustrative List. See WTO – UNEP Report, above n 2755, at 105.

2790 Emphasis added. Compare item (h) *juncto* footnote 61 of the SCM Agreement with item (h) of the Subsidies Code. See also *Note by the Secretariat*, *Negotiating history of footnote 61 of the Agreement on Subsidies and Countervailing Measures* (WT/CTE/W/16, 1 December 1995).

2791 As cited in full by de Cendra, a US trade official wrote to the US Council for International Business that:

> 'The change in question [i.e. insertion of footnote 61] was proposed to address a specific and very narrow issue involving certain energy-intensive exports from a limited number of countries. It was never intended to fundamentally expand the right of countries to apply border adjustments for a broad range of taxes on energy, especially in the developed world. We have discussed the matter with other developed countries involved in the Subsidies Code negotiations. We are satisfied that they share our views on the purpose of the text as drafted and the importance of careful international examination before any broader policy conclusion should be drawn regarding border adjustments and energy taxes'.

See de Cendra, above n 2658, at 140. The US feared that European or Asian countries would implement such rebates (Hufbauer, above n 2788, at 50).

2792 See also de Cendra, above n 2658, at 140; Hufbauer, Charnovitz, and Kim, above n 2658, at 46.

2793 J. A. Hoerner and F. Muller, 'Carbon Taxes for Climate Protection in a Competitive World', *Paper for the Swiss Federal Office for Foreign Economic Affairs* (June 1996), 47 pp., at 32-33; Schlagenhof, above n 2636, at 144; de Cendra, above n 2658, at 140. For the definition of 'cumulative' indirect taxes, see footnote 58 of the SCM Agreement.

2794 Hoerner and Muller, above n 2793, at 34.

distribution of exported products (see item (g) of the Illustrative List).[2795] Considering the diversity in opinions and lack of clarity in the legal texts, one cannot but conclude that the status of BTAs on energy/carbon taxes remains ambiguous under the SCM Agreement.[2796]

2.1.1.2.3.2. Emission trading schemes

As an alternative tool to reduce greenhouse gas emissions, countries are implementing emission trading schemes. Under such cap-and-trade systems, an annual cap on total emissions is set and emission permits up to this ceiling are allocated either for free or by governmental auctioning. Such allocated emission permits could next be traded among entities, implying that the emission reduction will be undertaken by the most cost-efficient entity. Liable entities are thus required to hold emission permits (either initially allocated by the government or subsequently purchased on the market) covering their actual level of emissions. Two somewhat opposite queries have puzzled international trade scholars. First, could the burden imposed on domestic firms under such cap-and-trade systems be adjusted at the border? Second, could emission permits allocated for free under such a cap-and-trade system be qualified as a specific subsidy and thus be disciplined under the SCM agreement? Whereas the first question thus seems to suggest that domestic firms are bearing an extra *burden* for which they might have to be compensated, the second seems to hint that domestic firms receiving free emission permits are *subsidized*, against which foreign countries might take action.[2797] This apparent ambiguity results from the fact that a *regulatory* system is set

[2795] Indirect taxes are defined as 'sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and *all taxes other* than direct taxes and import charges' (footnote 58 of the SCM Agreement; emphasis added). Because they do not qualify as direct taxes, carbon/energy taxes are therefore covered under 'indirect taxes'. See Pauwelyn, above n 2658, footnote 47. Likewise, Hufbauer et al make this argument but also formulate the counterargument that, even though energy taxes are indirect taxes, they might be exclusively dealt with under item (h) of the Illustrative List. See Hufbauer, Charnovitz, and Kim, above n 2658, at 45-66.

[2796] Three positions could be distinguished on whether carbon/energy taxes could be legally rebated upon exports. Notice hereby that scholars often refer to different arguments even when they reach a similar conclusion. First, authors generally considering BTAs on energy taxes as allowed: F. Biermann and R. Brohm, 'Implementing the Kyoto Protocol without the USA: the Strategic Role of Energy Tax Adjustments at the Border', 4 *Climate Policy* (2005), 289-302, at 297-298; Pauwelyn, above n 2658, at 19; Van Calster, above n 2784, at 433-437. Next, authors dismissing the legality of BTAs on energy taxes: Schlagenhof, above n 2636, at 143-144. Lastly, mixed views are expressed by: Demaret and Stewardson, above n 2789, at 29-30; M. Genasci, 'Border Tax Adjustments and Emissions Trading: The Implications of International Trade Law for Policy Design', 1 *Carbon and Climate Law Review* (2008), 33-42, at 36; Hufbauer, Charnovitz, and Kim, above n 2658, at 41-42; de Cendra, above n 2658, at 140.

[2797] This complexity has resulted in opposite conclusions reached by trade experts. On the one hand, Shah concluded that free allocation of emission permits under cap-and-trade systems could be qualified as an actionable *subsidy*. On the other hand, Pauwelyn reached the opposite conclusion. A *cost or tax* (and thus not a subsidy) is still imposed upon liable entities when allowances are handed out for free, which could arguably be adjusted at the border for imports. Under the first reading of exactly the same system, trading partners could undertake multilateral or unilateral action, while under the second reading, the cap-and-trade imposing country would be allowed to make border adjustments. I will explain why both propositions seem to too extreme. See Pauwelyn, above n 2658, at 21-22; V. R.

up creating a *market* whereby some or all permits might initially be allocated for *free*. If so, a regulatory burden (i.e., the obligation to hold permits up to emission levels) is combined with a free allocation of permits. Any suggested theory for analyzing cap-and-trade systems under the SCM Agreement has to solve both inquiries in a mutually consistent way.

Starting with first query on whether the allocation of emission permits for free could be challenged (or countervailed) under the SCM Agreement, I would suggest the following solution. Free allocation would seem not to be disciplined under the SCM Agreement if *all* permits are allocated for free, which is the approach taken under the initial cap-and-trade schemes in the EU.[2798] Therefore, I tend to disagree with Shah's conclusion that the German cap-and-trade system could be actionable under the SCM Agreement.[2799] Yet, if such free permits were only granted for free to certain enterprises, they would seem to fall within the subsidy definition of the SCM Agreement. An example thereof is Australia's announced cap-and-trade system (i.e., the Carbon Pollution Reduction Scheme (CPRS)), under which only firms producing export goods that have a significant economic exposure to higher carbon prices (so-called 'Emissions-Intensive Trade Exposed' or EITI entities) will be allocated free emission permits.[2800] Here, I concur with the conclusion of Feaver et al that this might constitute a specific subsidy under the SCM Agreement. To underpin this proposed solution, the subsequent analysis under the SCM Agreement is advanced.[2801]

The first threshold question is whether free emission permits can be considered as a 'financial contribution' under the SCM Agreement. First of all, Feaver et al have argued that, in light of *US – Softwood Lumber IV*,[2802] a free emission permit could fall within the scope of Article 1.1(a)(1)(iii) of the SCM Agreement as the provision of '*goods*' by the government.[2803] Yet, most other authors have rightly objected that an emission allowance does not seem to qualify

Shah, 'The Allocation of Free Emissions Allowances by Germany to its Steel Industry: A Possible Subsidy Claim under the WTO Agreement on Subsidies and Countervailing Duties', 22:3 *American University International Law Review* (2007), 445-478.

2798 To be sure, Mattoo et al have advanced that, in economic terms, such free allowances might operate as production subsidies depending on the conditions set under the cap-and-trade system: 'if the allowances are related to historical output (it has been proposed that they be related to output in the previous two years), then they would amount to a lump-sum transfer without any marginal impact on production decisions, and hence on trade. Alternatively, producers' knowledge that future allowances are related to current output could have an impact on current decisions on output. In this case, allowances would be closer to a production subsidy'. See Mattoo, Subramanian, van der Mensbrugghe, and He, above n 2785, at 4.

2799 Shah, above n 2797.

2800 See D. Feaver, W. McGoldrick, and V. Boyd-Wells, 'Is Australia's EAP a Prohibited Export Subsidy?', 44:4 *Journal of World Trade* (2010), 319-347.

2801 This would also meet the strong 'trade policy grounds for treating allowances as subsidies' that were raised by Hufbauer et al. Deciding otherwise would mean that governments would be able 'to avoid all subsidy disciplines by using the form of tradable emissions allowances to confer aid on *favored* industries or agricultural producers'. Hufbauer, Charnovitz, and Kim, above n 2658, at 62 (emphasis added).

2802 See above Part II, Chapter 3, Section 3.1.1.2.

2803 Feaver, McGoldrick, and Boyd-Wells, above n 2800, at 335.

as a good. Hufbauer et al have argued that 'unlike a right to timber whereby timber itself is a good, a right to generate greenhouse gas emissions is not a right to a good because greenhouse gas emissions are not a good as the term is commonly used'.[2804] Alternatively, Feaver et al and Shah have suggested that free emission permits would be covered under a '*direct transfer of funds*' (Article 1.1.(a)(1)(i) of the SCM Agreement) because such permits have a market value and could be traded.[2805] In support of this reading, recall that the Appellate Body has endorsed a broad interpretation of 'funds', which not only covers money but also financial resources and other financial claims more generally. Still, I doubt whether the Appellate Body would deem free allowance permits to be sufficiently similar to the listed forms of direct transfers of funds so as to be covered under this form of financial contribution.[2806] After all, non-listed forms (e.g., interest rate reduction) that were included shared the feature that the financial position of the borrower was *improved*.[2807] Arguably, the cap-and-trade schemes' intrinsic link between, on the one hand, the allocation of emission permits ánd, on the other hand, the obligation to hold emission rights up to actual emission levels might put in question whether the financial position of liable entities has in fact ameliorated.[2808] Even if allowances are offered for free, the purpose of such cap-and-trade scheme is to increase the burden upon emitters (e.g., reduce emission levels) rather than to improve liable entities' financial position.[2809] Moreover, a potential downside of this qualification is that companies simply left out of the scheme (i.e., not made subject to emission ceilings) would never be captured as they are not given a direct transfer of funds. Therefore, I would only assess free allowance permits of a cap-and-trade system under the '*revenue foregone*' category (Article 1.1(a)(1)(ii)). Applying the test developed in the *US – FSC* cases, the relevant inquiry here is whether a WTO Member has given up an entitlement to raise revenue that it would otherwise have collected. This benchmark refers to the fiscal treatment of 'legitimately comparable income' in the domestic system of the WTO Member in question. Thus, like rightly concluded by Feaver et al, Australia would forego revenue under its cap-and-trade system because it would auction emission permits to all emitters *except* to those that qualify as EITI-entities. Arguably, also when some large comparable emitters would not be made subject to the cap-and-trade scheme, revenue would be

[2804] Hufbauer, Charnovitz, and Kim, above n 2658, at 62.
[2805] Feaver, McGoldrick, and Boyd-Wells, above n 2800, at 333; Shah, above n 2797, at 463-464.
[2806] Appellate Body Report, *Japan – DRAMs (Korea)*, para 251.
[2807] Appellate Body Report, *Japan – DRAMs (Korea)*, para 252.
[2808] Admittedly, this is a limited exception to the general rule that the subsidy definition disregards the regulatory burden imposed upon recipients. In my opinion, this is justified by the intrinsic link between both elements in cap-and-trade schemes (see above n 2760). See also Bigdeli, above n 2658, at 162.
[2809] Because the requirement to hold emission allowances does impose an opportunity cost, Pauwelyn has advanced the opposite argument, namely that 'free allowances impose *a cost or tax* that could arguably be sold on the market' (emphasis added). Pauwelyn, above n 2658, at 22.

foregone.[2810] On the other hand, no revenue would be foregone under cap-and-trade systems that allocate *all* emission rights for free (e.g., German system) because the benchmark is the fiscal treatment in the WTO Member in question.[2811] This reasoning would have the advantage that it would, to some extent, treat carbon tax systems and cap-and-trade systems equally under the SCM Agreement.[2812] WTO Members are not obliged to tax (auction) carbon emission (rights) but if they do so, they should tax (auction) all carbon emission (rights) in a comparable way.

The presence of 'revenue foregone' also implies that a benefit is conferred.[2813] In the Australian case, the EITI-entities enjoy a benefit as they are granted free emission allowances whereas other emitters in Australia have to purchase such permits.[2814] In contrast, the benefit analysis might also offer an additional argument to assert that the German cap-and-trade system is likely not a subsidy under the SCM Agreement. To arrive at a positive benefit conclusion, Shah compares the free allocation of permits with an 'efficient emissions trading market', whereby emitters would have to purchase permits and thus would pay fair market value.[2815] Yet, the benchmark for the benefit analysis is not an abstract efficient market but in principle refers to domestic conditions.[2816] Again, the difference in conclusion seems to result from his narrow focus on the value of emission permits, whereas I would suggest that the allocation of these permits is inherently connected to the obligation to hold such permits up to effective emission levels.[2817] In Shah's reasoning, emitters receiving free emission permits are subsidized under the SCM Agreement because the government transfers for free something having market value. Yet, this line of reasoning seems to neglect that such

[2810] Admittedly, no subsidy would exist under this analysis if some sectors are excluded from the obligation to cap emissions and *all* allowances are allocated for free to the sectors covered under the cap-and-trade system. After all, no revenue would be foregone.

[2811] See also de Cendra, above n 2658, at 138.

[2812] With the important difference that if a cap-and-trade system is installed an incentive to reduce emissions is introduced also if emission permits are allocated for free. In contrast, if no carbon tax is imposed, no such incentive exists. Hence, deciding that a cap-and-trade system with free emission rights would be a subsidy under the SCM Agreement, whereas imposing no carbon tax at all would not be considered a subsidy would put the former system at a serious disadvantage and could not be endorsed from the perspective of environmental protection.

[2813] See above Part II, Chapter 3, Section 3.2.

[2814] See also Feaver, McGoldrick, and Boyd-Wells, above n 2800, at 335-336.

[2815] Hufbauer et al adopt the same reasoning as Shah does. If an emission allowance would be a good under the SCM Agreement, its free allocation would confer a 'benefit' as it could be traded afterwards on the market. Hufbauer, Charnovitz, and Kim, above n 2658, at 61, footnote 104.

[2816] Observe that the market is essentially created by the government in case of cap-and-trade systems.

[2817] Shah holds that '(i)n an efficient emissions trading market, installations have the incentive to invest in low carbon technology to avoid buying emissions allowances in the market. However, when Germany allocates free emissions allowances, these incentives disappear because installations will not have to pay for allowances. Therefore, under Germany's NAP, installations receive allowances on terms more favourable than the terms they would otherwise receive in the market'. Shah, above n 2797, at 465-466. Yet, this conclusion is too stark because the requirement to hold allowance permits and the right to trade these permits also gives firms an incentive to cut emissions so as to sell their rights on the market. In case a low ceiling would be set, this would certainly increase firms' production costs. See also Pauwelyn, above n 2658, at 22; de Cendra, above n 2658, at 138.

allocation carries with it an obligation upon emitters to hold such permits up to their actual level of emissions.

Likewise, Shah's conclusion that the specificity test is passed when all emission permits are allocated for free is questionable.[2818] When all emitters in the market receive these permits for free, such allocation would likely not be specific to certain enterprises under Article 2 of the SCM Agreement.[2819,2820] I also differ from Shah's argumentation that the fact that some sectors (e.g., transport or household) are exempted from the German cap-and-trade scheme, and thus do not receive free emission allowances, suffices to make such free emission permits specific. Such reasoning precisely illustrates the odd legal consequences of a narrow focus. It assumes that the sectors left out of the cap-and-trade system are worse off (as they do not receive the specific subsidy), whereas they might in fact be better off (as they do not have to hold emission rights). Turning back to the Australian cap-and-trade scheme, the exemption for EITI-entities does indeed seem 'specific' within the rather broad meaning given to this concept in the case law because it is targeted to carbon-intensive industries.[2821] Moreover, when this exemption would qualify as *de facto* contingent upon exportation (Article 3.1(a) of the SCM Agreement), specificity is even assumed (Article 2.3 of the SCM Agreement). Here, Feaver et al reveal that the exemption for EITI-entities is contingent upon exportation because one of the eligibility criteria is a 10% export requirement.[2822] In light the Appellate Body interpretation in *Canada – Autos*, such a ratio specifying an obligation to export a certain proportion of production is in their view 'contingent in law' upon exportation and therefore qualifies as a prohibited subsidy under the SCM Agreement.[2823] If no export contingency would be found, they correctly conclude that the free allowances to EITI-entities would still be vulnerable to an actionable subsidy claim and/or CVDs response.[2824]

[2818] Shah, above n 2797, at 470. In his alternative reasoning, Shah also forgets that the non-actionable subsidy category no longer exists. See Shah, above n 2797, at 471-473.
[2819] Arguably, the objective-criteria exemption could be relied upon. This would also not be *de facto* specific.
[2820] Shah argues that some sectors (e.g., transport and household) are left out of the cap-and-trade scheme and thus do not receive free emission allowances. Yet, these sectors are also not subject to cut their emissions under the cap-and-trade scheme. Shah, above n 2797, at 470.
[2821] Hufbauer, Charnovitz, and Kim, above n 2658, at 89; Feaver, McGoldrick, and Boyd-Wells, above n 2800, at 337.
[2822] Feaver, McGoldrick, and Boyd-Wells, above n 2800, at 338-339.
[2823] While this final conclusion might be correct as firms are given an incentive to start exporting so as to meet this threshold, observe however that the 'tie' between export performance and subsidy allocation seems less strong compared to the *Canada – Autos* case. Indeed, all entities meeting this (rather low) export requirement are eligible for free allowances and the level of free allowances does not increase with exportation but is related to their emission-intensity.
[2824] Feaver, McGoldrick, and Boyd-Wells, above n 2800, at 339. Of course, both actions could still be undertaken even if the measure would be categorized as a prohibited subsidy.

This leads us to the second query on carbon-and-trade systems: Could the burden imposed under cap-and-trade systems be adjusted upon exportation? On the one hand, the auctioning of emission permits could qualify as a 'tax' because a payment is made to the government for which taxpayers receive nothing identifiable in return.[2825] Comparable to the analysis of a carbon/energy tax rebate, a similar argument could thus be made that auctioned emission permits could be recovered upon exports as a rebate of an 'indirect tax' (by virtue of footnote 1 of the SCM Agreement and item (g) of the Illustrative List).[2826] Ismer and Neuhoff emphasize that in case only a fraction has to be purchased from the government, the cost of buying the emission permits should be spread over all the allowances in calculating the level of rebates.[2827,2828] If such rebates would be accepted, it would offer a WTO-compatible option to ease the burden of auctioned emission trading systems upon exporters.[2829] On the other hand, as de Cendra correctly suggested, if *all* emission permits would be given for free instead of auctioned, no 'tax' would be imposed and no adjustment upon exportation could be made. This would indeed be similar to the imposition of non-fiscal measures for which exporters could also not be compensated.[2830] As such, the allocation of emission permits for free to all emitters would be neither a countervailable/challengeable subsidy nor a tax that could be rebated upon exportation.[2831]

In conclusion, this rather complicated and speculative analysis of carbon tax and cap-and-trade systems under the SCM Agreement has amply shown that the WTO framework is not the optimal instrument to discipline such systems. Indeed, international environmental agreements outside the WTO framework are superior to allocate the burden of reducing emissions among different countries. As long as no such satisfactory multilateral solution

[2825] Ismer and Neuhoff have defined a tax as 'a compulsory contribution imposed by government for which taxpayers receive nothing identifiable in return for their contribution'. According to de Cendra, the essential feature of a tax is the existence of a payment to the government. See R. Ismer and K. Neuhoff, 'Border Tax Adjustment: A Feasible Way to Support Stringent Emission Trading', 24 *European Journal of Law and Economics* (2007), 137-164, at 144; de Cendra, above n 2658, at 135.

[2826] But again, the initial question whether such a tax would be covered as an 'indirect tax' is not settled.

[2827] For instance, '(i)f half of the allowances in circulation were allocated to each business free of charge and the second half had to be bought for a price of 100, the price used for adjustment purposes would be 50'. Ismer and Neuhoff, above n 2825, at 144.

[2828] On the complexities of implementing such BTAs on exports in case of cap-and-trade systems, see Genasci, above n 2796, at 39-41.

[2829] Hence, only the costs of auctioned emission permits on effectively *exported products* could be rebated. Notice the difference with the Australian cap-and-trade system, whereby *entities* meeting the 10% export requirement (i.e., being trade-exposed) and the emission-intensity requirement receive free permissions. Their level of free permissions depends on their emission-intensity (the most intensive activities receive 94.5% of their required emissions for free, less emission-intensive firms are eligible for 66%). On the details of the Australian exemption for EITI entities, see Feaver, McGoldrick, and Boyd-Wells, above n 2800, at 325-326.

[2830] de Cendra, above n 2658, at 135-136.

[2831] See above n 2797.

among all major carbon emitting countries is achieved, individual countries' action (and inaction) will evoke claims of 'unfair trade' and puzzle international trade lawyers' minds.

2.1.1.3. Assistance to disadvantaged regions

Next to R&D subsidies and some environmental subsidies, the SCM Agreement provided a carve-out for assistance to disadvantaged regions (Article 8.2(b) of the SCM Agreement). Such a region had to be a geographical area with a definable economic and administrative identity that was considered 'disadvantaged' on the basis of objective and economic criteria.[2832] Moreover, assistance had to be given pursuant to a general framework of regional development and qualify as non-specific (within the meaning of Article 2 of the SCM Agreement) within that region.

Although disparities in income levels between regions might very well be explained in economic terms (e.g., clustering, differences in natural resources), such carve-out for assistance to disadvantaged regions might at the same time be legitimate for redistributive reasons. Furthermore, systemic considerations could equally underpin the call for re-activating its green light status. Recall that, by virtue of Article 2.2 of the SCM Agreement, general subsidies granted by the regional government *itself* are likely considered as non-specific and thus exempted from disciplines under the SCM Agreement and CVDs action, which is deemed justified because it respects the federal structure of WTO Members. On the other hand, such generally available regional subsidies granted by the national government would be specific. Hence, the carve-out ensured that unitary WTO Members could likewise support disadvantaged regions without being captured by the SCM Agreement. In this sense, the carve-out would put all WTO Members on an equal footing, at least with respect to support for *disadvantaged* regions.[2833]

2.1.1.4. Multifunctionality in agriculture

A number of developed countries (e.g., Japan, Korea, Norway, Switzerland, and the EC) rely upon the multifunctionality argument to defend larger policy space for agricultural support. Their argument is that agriculture cannot simply be treated like any other sector because it generates specific positive externalities such as landscape preservation and food security. Yet, these legitimate non-trade concerns certainly do not justify the large amounts of trade-distortive support provided by developed countries. As the discussion in Part I has revealed, this multifunctionality argument hinges on the assumption of 'jointness of production' if used

[2832] See above Part II, Chapter 3, Section 3.3.4.
[2833] As explained above in Part II, there is no economic rationale that could explain why similar subsidies would be disciplined differently simply on the basis of the granting authority.

to justify support linked to output levels. This assumption does often not hold in practice. For instance, the objective of landscape preservation could be pursued in a more targeted way than by subsidizing output levels. Likewise, the frequently mentioned objective to ensure food security might have to be nuanced insofar it is articulated by high-income countries. Indeed, a group of leading European agricultural economists has questioned the 'food security'-argument in a threefold way.[2834] First, developed countries, like European countries, have sufficient purchasing power to source food from the world market even in times when food prices are high. Equally, poor households could be assisted in a more targeted way than by subsidizing domestic support (e.g., social security system). Second, in order to preserve the capacity to raise production if a future need would arise, targeted payments (e.g., to preserve soil fertility or maintain a critical level of farming activity) are more effective than blanket subsidies maintaining existing agricultural production levels. Third, the argument that existing support levels in developed countries would be helpful to reach *world* food security is untenable. Addressing food security concerns in developing countries would be better pursued by development assistance (e.g., to agricultural research and infrastructure) than by supporting domestic producers. Indeed, large amounts of domestic support in developed countries seem rather detrimental to the vital objective of securing food security in developing countries in the long-term.

In my view, the overall conclusion is that the multifunctionality argument can not justify the substantive leeway given to trade-distortive support under the Agreement on Agriculture. Under existing disciplines, WTO Members are allowed to offer an unlimited amount of blue box support as well as a *de minimis* level of production-stimulating support (i.e., *de minimis* box). In addition, trade-distortive production stimulating support could be offered up to reduction commitment levels (i.e., amber box support *sensu stricto*).[2835] Developed countries' reduction commitments undertaken during the Uruguay Round were far from demanding. Hence, it should be welcomed that more serious cuts in trade-distortive support levels are tabled in the Doha Round. Importantly, not only a gradual reduction in the overall level of trade-distortive support will have to be implemented but product-specific limits will also have to be respected. In practice, major subsidizing developed countries such as the EC and US are already moving towards less trade-distortive decoupled payments and other forms of green box support. However, their level of green box support has raised the concern that trade flows would still be distorted. Yet, no limits are currently set on such green box support and the latest drafts circulating in the Doha Round do not provide for a ceiling as well.

[2834] They advocated a further reform of the European Common Agricultural Policy. See *A Common Agricultural Policy for European Public Goods: Declaration by a Group of Leading Agricultural Economists* (18 November 2009), 5 pp., at 2.

[2835] At least, insofar the WTO Member in question had such non-exempted amber box support in place.

Notwithstanding this leeway given under the Agreement on Agriculture on various types of domestic support, agricultural support is vulnerable to an actionable subsidy claim or CVDs action under the SCM Agreement. Since the expiration of the peace clause, no restraint is any longer in place on challenging trade-distortive agricultural subsidies before the WTO. In principle, the application of the SCM Agreement seems warranted in light of the weakness of the multifunctionality argument to justify large levels of production stimulating agricultural support. Yet, the vulnerability to an actionable subsidy claim might make countries reluctant to cut tariff levels. This systemic criticism on domestic subsidy disciplines imposed under the SCM Agreement has been formulated by Bagwell and Staiger. We turn to their argumentation in the following section.

2.1.2. Systemic considerations: Chilling effect on tariff negotiations

Bagwell and Staiger have offered a fundamental systemic criticism on the SCM Agreement disciplines on domestic subsidies. In particular, they have argued that these disciplines could have a 'chilling effect' on the willingness of governments to undertake tariff negotiations and that more flexible GATT disciplines are therefore preferred.[2836] On the one hand, Bagwell and Staiger emphasize that governments should retain sufficient policy space to offer domestic subsidies so as to correct domestic market failures. The targeting principle implies that domestic market failures should preferable be corrected by domestic instruments such as domestic subsidies and not by tariffs, as the latter also negatively affect consumers in the domestic market.[2837] On the other hand, Bagwell and Staiger acknowledge that some restraint on domestic subsidization seems needed because such a subsidy could erode a market access commitment made as part of a tariff concession. After all, a tariff could simply be replaced by a production subsidy combined with a consumption tax (i.e., equivalence). Once a tariff concession is made, a country could be tempted to compensate its domestic import-competing industry with a domestic subsidy and, in this way, erode the market access commitment.[2838] If a trading partner anticipates such reaction, it would be reluctant to accept the tariff binding in the first place and to bind its own tariffs as a *quid pro quo*. Given these opposite perspectives, how should multilateral disciplines on domestic subsidies look like? Bagwell and Staiger

[2836] See K. Bagwell and R. W. Staiger, 'Will International Rules on Subsidies Disrupt the World Trading System?', *The American Economic Review* (June, 2006), 877-895; K. Bagwell, 'Remedies in the WTO: An Economic Perspective', *Working Paper* (January 9, 2007), 34 pp.; A somewhat similar argument was developed by Janow and Staiger, above n 2635, at 220-228.
[2837] Next to domestic market failures, Bagwell also indicates that subsidies can be useful to a government that seeks to redistribute income in a manner that enhances its political-economy welfare. However, this political-economy argument is hard to accept under a normative analysis.
[2838] By limiting market access, the domestic subsidy to the import-competing industry would put downward pressure on the world price. This generates a terms of trade benefit to the subsidizing country and a terms of trade loss – and thus welfare loss – to the rest of the world. Of course, this assumes that the subsidizing country is large.

have developed a model showing that the SCM disciplines are inferior to the GATT disciplines in case governments attach sufficient weight to correcting domestic market failures. If a tariff is bound, a government could only stimulate domestic production by providing a production subsidy. Yet, such a subsidy could subsequently be challenged, in which case it will have to be removed.[2839] On the other hand, if a tariff would be unbound, it would be less likely that a domestic subsidy would be challenged as the government could still use a tariff as second-best option. Indeed, a foreign government would not likely challenge such a domestic subsidy when the alternative, namely a tariff, would still be available and would make the foreign country even worse off.[2840] Consequently, the best choice for countries that sufficiently value the use of subsidies might be to leave tariffs unbound. As a result, the SCM Agreement could have a 'chilling effect' on countries' willingness to enter mutually beneficial tariff negotiations. In Bagwell's words:

> This discussion suggests a "Goldilocks" principle for the treatment of domestic subsidies. If disciplines on subsidies are too lax, then subsidies can be used to erode market access concessions and governments will thus hesitate to undertake reciprocal tariff negotiations; however, if subsidies are disciplined too severely, then governments may also hesitate to negotiate tariff bindings, since tariffs then may be the best remaining means of assisting domestic import-competing industries.[2841]

In Bagwell's opinion, the non-violation complaint that was already present under GATT disciplines struck this balance 'just right'. If a subsidy was offered to exporting producers, the GATT disciplines allowed foreign governments to protect their import-competing industries with CVDs in case the subsidy caused material injury. If a subsidy was offered to import-competing producers, a foreign government which had negotiated tariff bindings could formulate such a non-violation complaint. As explained in Part II, both instruments to respond to foreign subsidization were indeed inscribed by the original drafters of the GATT so as to safeguard tariff negotiations.[2842] In contrast, the SCM Agreement disciplines are considered too restrictive as they impose disciplines on domestic subsidies even when they do not nullify or impair any negotiated market access benefit.[2843]

However, some elements could question aspects of this normative argument regarding SCM Agreement disciplines as formulated by Bagwell and Staiger. First, as a technical clarification, their model is developed for interactions between large countries. Indeed, as

[2839] Bagwell and Staiger recognize that, from a legal perspective, the domestic subsidy should not necessarily be withdrawn (see above Part II, Chapter 5, Section 5.1.3.2.1). But because the pressure upon governments to do so would be far greater under the SCM Agreement, their model assumes that such subsidies should be withdrawn. See, Bagwell and Staiger, above n 2836, at footnote 11.

[2840] Indeed, a production subsidy to import-competing industries is less welfare-reducing for foreign countries than a tariff. Y-H. Yeh, 'On Subsidies vs. Tariffs', 38:1 *Southern Economic Journal* (July, 1971), 89-92, at footnote 3.

[2841] Bagwell, above n 2836, at 26.

[2842] See above Part II, Chapter 1, Section 1.1.

[2843] Bagwell, above n 2836, at 26-27.

also Bagwell stresses, only large countries can affect the terms of trade through, *inter alia*, tariffs and domestic subsidies.[2844] Because tariffs are optimal instruments for large countries to alter the terms of trade (i.e., to correct this 'international distortion'), the superiority of production subsidies as optimal instrument to correct domestic distortions is not self-evident if only one of both instruments can be employed in the presence of both distortions. Surely, this clarification does not undermine the idea that countries would shift to tariffs anyway in case domestic subsidies are unavailable and, thus, that third countries would in that case be always worse off.

Second, only domestic subsidies that are specific and cause adverse effects could be challenged.[2845] The hurdle for bringing such a claim – which requires a considerable amount of human and financial resources – as well as the fact that those subsidies will not *per se* have to be removed if a violation is found, might suggest that the dynamism underlying the 'chilling effect' should somewhat be nuanced.[2846] Likewise, the unilateral CVDs option requires substantial human and financial resources and does not necessarily lead to the removal of the subsidy. If countries attaching importance to correct domestic market failures take on board these aspects of domestic subsidy claims and CVDs action, they might still agree to go into mutually advantageous tariff concessions. Again, this observation qualifies but does not rule out the central idea of the Bagwell and Staiger model.

Third, the burden on formulating a non-violation claim under the GATT era was set high by GATT panels and this restrictive interpretation is also followed under WTO law. Given that it should be demonstrated that the effect of a tariff concession is *systematically* offset by a subsidy programme, the non-violation complaint was – and still is – not regarded as an effective instrument by GATT/WTO Members.[2847] Here, the model of Bagwell and Staiger might suggest that this burden should not be interpreted so restrictively (i.e., normative theory perspective). Yet, the requirement to demonstrate the causation element inherent in a non-violation complaint (i.e., the benefit of a tariff concession is undermined *by* a subsidy) cannot be circumvented.[2848]

Fourth, it is not demonstrated that Bagwell and Staiger's theoretical model holds in practice. Indeed, it is unclear whether tariff negotiations are effectively undermined by the more

[2844] Hence, the terms of trade theory of trade agreements would suggest that small countries should be free to adopt tariffs and subsidies. Bagwell, above n 2836, at 4.

[2845] See above Part II, Chapter 4, Section 4.2.

[2846] It is important to reiterate that domestic subsidies are not WTO-inconsistent *as such* but only if they have been proven to cause adverse effects to the interests of other WTO Members.

[2847] See above Part II, Chapter 1. Citing the Panel in *Japan – Film*, the Appellate Body in *EC – Asbestos* also confirmed that the remedy in Article XXIII:1(b) of the GATT 'should be approached with caution and should remain an exceptional remedy'. Appellate Body Report, *EC – Asbestos*, para 186.

[2848] Although it considered that a non-violation complaint should be of an exceptional nature, the Panel in *Japan – Film* has put the causation standard relatively low as it only asked for 'more than a *de minimis* contribution to nullification or impairment'. Panel Report, *Japan – Film*, paras 10.36, 10.84.

stringent rules on domestic subsidies. In this respect, a puzzle left unexplained under their model is why countries have agreed to such strengthening of domestic subsidies in the Uruguay Round if doing so would undermine tariff negotiations (i.e., positive theory perspective).

Fifth, two improvements of the SCM Agreement's adoption are not incorporated in Bagwell and Staiger's basic model. These authors suggest that one major limitation perceived by GATT Members and not integrated in their two-country model was the inability to address third-country issues under GATT rules.[2849,2850] Therefore, stricter disciplines were drafted in the SCM Agreement because GATT/WTO Members wished to be able to challenge domestic subsidies causing displacement to their exporters in third-country markets. According to Bagwell and Staiger, however, a better fix to this concern would be 'to extend the reach of non-violation claims to third parties'.[2851] Although they do no elaborate how this should be done exactly, inspiration for their proposal might be found in a non-adopted GATT Panel Report (*Spain – Soyabean Oil*). This is the only GATT Panel that attempted to bring third-country issues under the scope of the non-violation complaint. Reviewing a non-violation complaint of the US against GATT-consistent restrictions imposed by Spain on the internal sale of soyabean oil, the GATT Panel came to the vague conclusion that it:

> (…) could not entirely exclude the possibility that the Spanish measures (…) could have had some effects on Spanish exports of soyabean oil in such a way as to displace exports of soyabean oil by the United States from some of its traditional markets, and thus possibly nullifying or impairing benefits accruing to the United States (…).[2852]

Hence, the GATT Panel considered that such an internal restriction, similar to a domestic (or export) subsidy, could have an export-stimulating effect and hereby displace US exports to third countries. However, it is telling that the Panel's reasoning failed to clarify an essential aspect of the non-violation complaint: which benefits to the US *under* the GATT (e.g., tariff concessions) were exactly nullified? Demonstrating that a GATT-consistent export-stimulating measure (e.g., domestic subsidy) by one country (Spain; Country B) nullifies or impairs to another country (US; Country A) previous tariff concessions made by third countries (Country C) seems indeed notoriously difficult, if not simply impossible. After all, tariff concessions made by Country C are unrelated to, and could principally not be nullified

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[2849] To be precise, the Subsidies Code also offered very limited potential to challenge subsidies causing adverse effects in third country markets.

[2850] As shown in the historical overview, this was in particular perceived as a limitation by the US. Importantly in my view, other countries agreed to draft domestic subsidy disciplines in exchange for stricter disciplines on CVDs. The original GATT did not struck this part of the balance 'just right' because it in practice opened the door to impose CVDs beyond what was needed to respond to genuine foreign subsidization.

[2851] Their model could be extended along these lines (3-country model). Bagwell and Staiger, above n 2836, at 893.

[2852] GATT Panel Report, *Spain – Soyabean Oil*, para 4.14.

by,[2853] subsequent subsidization by Country B. This illustrates the intrinsic difficulties of extending the non-violation complaints to third country issues as suggested by Bagwell and Staiger.[2854,2855]

A second improvement of the SCM Agreement is not incorporated in Bagwell and Staiger's normative evaluation of the SCM provisions on domestic subsidies as well. As Sykes underscores, under the GATT regime domestic subsidies that harmed import-competing industries could only be countervailed (unilateral option) and could not be challenged multilaterally. This multilateral option is superior to unilateral CVDs as the latter introduce new distortions and may simply divert (inefficient) subsidization from the country imposing CVDs to other countries.[2856]

In sum, two important new avenues to address injury caused by domestic subsidies are not integrated in Bagwell and Staiger's plea for the GATT rules: existing disciplines allow the challenge of domestic subsidies causing injury in third-country markets (Country C) and, next to the old CVDs option, equally offer a multilateral option to tackle injury caused to import-competing industries (Country B). While their model should thus not lead to the conclusion that GATT rules are generally superior over the SCM Agreement, it might still suggest that injury caused in the subsidizing country (Country A) should be restricted to non-violation claims and should not be extended, as is done under the SCM Agreement Article 6.3(a), to situations were no prior tariff concessions were made. It might be objected that such a limited amendment would imply that adverse effects in exporting markets (Country B and C) are disciplined more severely than those effects in the country of the subsidizing country. But this asymmetry is similar to the one underlying the more stringent disciplines on export subsidies vis-à-vis tariffs (see below Section 2.2). At first sight, amending the current SCM Agreement disciplines in this limited way might leave the improvements of the SCM Agreement in place (e.g., option to tackle adverse effects in foreign markets) but might, at the same time, partly block the potential 'chilling effect'.

[2853] Strictly speaking, Country A is still better off as a result of Country C's tariff concessions, even when its share of exports to Country C is reduced because of subsidized exports from Country B. Only in case all exports are competed out of Country's C market as a result of subsidization, Country A no longer benefits from the tariff concessions.

[2854] Even if this could be extended, I do not see why such an extended non-violation complaint would be superior to the more detailed test for tackling adverse effects in third countries under the SCM Agreement. The argument that third country subsidization would have a 'chilling effect' on tariff negotiations assumes that countries (e.g., US) would be reluctant to enter into tariff negotiations because reciprocal concessions of third countries would be eroded by subsidization of another GATT Contracting Party (e.g., Spain).

[2855] See also Sykes, above n 2661, at 98 and 102.

[2856] This is considered by Sykes as an improvement under the assumption that SCM Agreement disciplines are successful in distinguishing 'good' (efficient) from 'bad' (inefficient) subsidies. In fact, this assumption does not hold in his view.

In conclusion, whereas the argument of Bagwell and Staiger might have to be questioned in some respect, their fundamental point could still be valid *in theory*: stringent rules on domestic subsidies could undermine tariff negotiations and this might have the perverse effect to push WTO Members towards the use of second-best instruments, namely tariff protection.[2857] Yet, two final considerations should be taken on board in evaluating the potential threat of such 'chilling effect' *in practice*.

First, given that tariff walls in developed countries are already largely struck down in the field of industrial products, any 'chilling effect' might be less severe in the field of non-agricultural market access (i.e., NAMA) negotiations.[2858] For developing countries, who still have more latitude to impose tariffs, the S&D treatment provisions on domestic subsidies precisely prevent such 'chilling effect'. Indeed, only the non-violation complaint (e.g., nullification or impairment of tariff concessions)[2859] seems present to challenge injury in the subsidizing developing country market.[2860] On the other hand, the 'chilling effect' might more likely occur in the field of agricultural market access negotiations. Tariffs are still widely employed to protect agricultural markets and the SCM Agreement disciplines on domestic subsidies unlimitedly apply to agricultural products since the expiration of the peace clause. In the context of agricultural subsidies, economic studies have shown that the overwhelming majority of existing welfare losses is related to tariffs and not to domestic subsidies.[2861] Hence, such a 'chilling effect' of the SCM Agreement on agricultural tariff negotiations could have serious negative consequences.[2862] This might support re-installing some sort of a limited peace clause whereby claims against adverse effects occurring in the subsidizing country would be confined to non-violation complaints.[2863]

Second, even if bound tariff levels would still leave some room for tariff protection on industrial products, the fundamental change in business practices towards international fragmentation of production (i.e., offshoring) has shifted struggling domestic industries' plea from tariff protection towards explicit subsidization. This is illustrated by the wide use of

[2857] This is certainly a second-best option from the viewpoint of the rest of the world and in most cases from the perspective of the subsidizing country as well.
[2858] Significantly, discussions on disciplining domestic subsidies started to intensify when tariff levels were reduced (i.e., Tokyo Round negotiations).
[2859] Strictly speaking, Article 27.9 of the SCM Agreement is not a non-violation complaint but it includes the same standard of nullification or impairment
[2860] Article 27.9 of the SCM Agreement.
[2861] See, for example, K. Anderson, W. Martin, and E. Valenzuela, 'The Relative Importance of Global Agricultural Subsidies and Market Access', 5:3 *World Trade Review* (2006), 357-376. These authors argue that negotiations on agricultural subsidies have received relatively too much attention in light of economic theory. Along the same lines, see B. Hoekman and D. Vines, 'Multilateral trade cooperation: What next?', *CEPR Discussion Paper Series* (September 2007), 34 pp., at 31.
[2862] As explained above, the SCM Agreement disciplines on domestic subsidies are fully applicable with regard to agricultural subsidies.
[2863] Mavroidis pleads for drafting a new peace clause. Mavroidis, above n 2853, at 210.

subsidies in response to the economic crisis.[2864] With vertically integrated supply chains, many domestic (downstream) industries would indeed be hurt if tariffs on the imports of parts and/or components are increased. Hence, even if subsidy disciplines would have a 'chilling effect' on tariff negotiations, this change in business practices could reduce the likelihood that governments would effectively raise tariffs up to their bound level. Instead, next to the abovementioned legal and practical burdens for challenging foreign domestic subsidization, the simple 'pot-and-kettles problem'[2865] implies that governments could opt for domestic subsidization quite undisturbedly. In this respect, the WTO Director-General's Annual Report 2009 even seems to point to a perverse effect of further relaxing the disciplines on domestic subsidies along the lines suggested by Bagwell and Staiger. Given that subsidization requires substantive resources, developed countries *de facto* have more policy space to support their industry than developing countries do. The Report raises the concern that such asymmetric use of subsidization might shift back some changes of production from developing towards developed countries. After all, 'anticipating that governments in rich countries are more likely to support the private sector using subsidies rather than tariffs in case of adverse economic circumstances, firms may choose to relocate some of their stages of production from poor to rich countries.'[2866] Turning back to the flexible GATT disciplines on domestic subsidies would only facilitate this relocation and deepen the asymmetry between developed and developing countries.

For these reasons, the systemic concern of a chilling effect on tariff negotiations resulting from disciplines on domestic subsidies could only underpin a limited amendment of the scope for challenging domestic support to agricultural products.

2.2. DISCIPLINES ON EXPORT SUBSIDIES

Under the perfectly competitive market assumption, it has been shown that no economic rationale could be given why governments would offer export subsidies.[2867] Subsidies offered by small countries lead to welfare losses in the form of consumption and production distortions. The welfare losses are even larger in case large countries subsidize export-competing sectors because these incur an additional terms of trade loss. Political-economy reasons might explain why these countries would, nonetheless, offer export subsidies. In

[2864] Grossman as cited in 'The nuts and bolts come apart', *The Economist* (28 March 2009), at 79-81. See also WTO, Trade Policy Review Body, Annual Report by the Director-General, *Overview of Developments in the International Trading Environment – Part B: Shaping Factors for Trade: Looking into the Future* (WT/TPR/OV/12, 18 November 2009), 39 pp., paras 103-122.

[2865] Challenging other governments' domestic subsidization could make the claimant vulnerable to counterclaims.

[2866] Annual Report by the Director-General, above n 2864, para 120.

[2867] See above Part I, Chapter 1, Sections 1.1 and 1.2.

political-economy terms, an export subsidy could be considered as a gain to an exporting country (e.g., rewarded by exporters) and a cost to an importing country (e.g., harm to import-competing industries). If the perfect market assumption is relaxed, governments might also offer export subsidies in order to correct market failures or exploit strategic trade opportunities (profit-shifting rationale).[2868]

Once it can be explained why individual governments offer export subsidies, a second puzzle emerges from a positive viewpoint: why do governments conclude multilateral disciplines on banning the leeway for export subsidies? From a normative viewpoint, it could additionally be assessed whether such policy constraints on export subsidies are justified. If the purpose of a trade agreement is, as Adam Smith argued, to maximize 'the wealth of nations' (i.e., world welfare as whole), it should be assessed to what extent trade rules on curtailing export subsidies spur welfare of the world as a whole.[2869]

Because third countries overall benefit from foreign export subsidies in the form of a positive terms of trade effect, 'the rest of the world' would in principle not be interested to prohibit export subsidies from large countries.[2870] Contrary to an agreement outlawing or reducing tariffs, an agreement prohibiting export subsidies can therefore certainly not be based on the general rationale to eliminate 'beggar-thy-neighbour policies' (i.e. policies that overall have a negative effect on trading partners.)[2871] To be precise, the rest of the world benefits but net-exporting countries and exporters in general are hurt as a result of foreign export subsidies.[2872] Export subsidies thus have a 'beggar-thy-neigbour-exporter' feature.[2873] Hence, those

[2868] Export subsidies could not be legitimized on the basis of redistribution concerns, given that domestic subsidies are less distortive to the reach this objective.

[2869] A. O. Sykes, 'Protectionism as a "Safeguard": A Positive Analysis of the GATT "Escape Clause" with Normative Speculations', 58:1 *The University of Chicago Law Review* (Winter, 1991), 255-305.

[2870] As they are left untouched by export subsidies from small countries, other countries would be indifferent about any rules restricting such subsidization.

[2871] D. Rodrik, *One Economics – Many Recipes – Globalization, Institutions, and Economic Growth* (Princeton: Princeton University Press, 2007), 255 pp., at 149, footnote 10; D. Rodrik, 'Growth After the Crisis', *Paper prepared for the Commission on Growth and Development* (May, 2009), 42 pp., at 24; In contrast, this 'beggar-thy-neighbour' argument is relevant for explaining reductions on import duties as these duties imposed by a large country result in a higher world market price and accordingly in a negative terms of trade effect to the rest of the world. Hence, the rest of the world and the world as a whole are hurt by such an import duty. As is well-known, the positive terms of trade effect of an import duty could explain why a welfare-maximizing large country would impose such an import duty in the first place (theory of optimal tariffs; see above n 31). According to Bagwell and Staiger, preventing such 'beggar-thy-neigbour' conduct exactly explains the reason for concluding multilateral trade agreements but this view is criticized by Ethier (see above n 522). K. Bagwell and R. W. Staiger, *The Economics of the World Trading System* (Cambridge: The MIT Press, 2002), 224 pp.; W. J. Ethier, 'The Theory of Trade Policy and Trade Agreements: A Critique', 23 *European Journal of Political Economy* (2007), 605-623.

[2872] Except in case of predatory subsidies, but there is little evidence that this occurs frequently.

[2873] On the 'beggar-thy-neighbour' aspect of profit-shifting subsidies (strategic trade settings), see J. A. Brander, 'Strategic Trade Policy', in G. M. Grossman and K. Rogoff (eds), *Handbook of International Economics – Volume 3* (Amsterdam: North-Holland, 1995), 1395-1455, at 1447.

exporters might put pressure upon their governments to offer export subsidies in response so as to compete for third-country export markets.[2874] The fact that producers have more political-economy leverage than consumers explains why governments would be willing to respond to this call.[2875] In oligipolistic markets with Cournot competition, exporting countries maximize welfare by offering export subsidies in response and thus start a subsidy war.[2876] Hence, the same political-economy or strategic trade arguments explain why those governments are willing to meet the call of their exporters and initiate a subsidy war. Alternatively, those countries might offer export subsidies in reply, and thus start a subsidy war, so as to induce foreign governments to stop subsidizing.[2877]

In the non-cooperative equilibrium (Nash-equilibrium), such a subsidy war might give rise to a prisoner's dilemma in which all exporting countries subsidize exports[2878] but would be better off if they concluded an agreement to curtail subsidization. Indeed, a subsidy war has severe budget implications, deteriorates exporting countries' terms of trade, and, by canceling out each other's subsidies, could result in a 'zero-sum operation' whereby no exporting country wins any market share.[2879,2880] However, given that no country could unilaterally

[2874] Import-competing industries are also hurt and might push for the imposition of CVDs. But imposing CVDs would not undo the negative effects on their exporters in third country export markets.

[2875] See, for example, R. E. Baldwin, 'The Economics of the GATT', in Peter Oppenheimer (ed), *Issues in International Economics* (London: Oriel Press, 1978), 335 pp., 82-93, at 86.

[2876] The highest level of subsidies is given by the country in which the most competitive firm is located. D. De Meza, 'Export Subsidies and High Productivity: Cause or Effect?', 19:2 *The Canadian Journal of Economics* (May, 1986), 347-350; D. Collie, 'Profit-Shifting Export Subsidies and the Sustainability of Free Trade', 40:4 *Scottish Journal of Political Economy* (November, 1993), 408-419.

[2877] Indeed, by matching foreign export subsidization with export subsidies, the costs upon foreign governments to offer export subsidies increases (see below n 2887).

[2878] Hence, the welfare cost upon the exporting country to continue subsidizing exports in competitive markets increases if the (parallel) response by third countries is taken into consideration. Only in case political-economy pressure is sufficiently high, governments will play the 'subsidy game' and thus offer export subsidies in competitive markets. In oligopolistic markets where firms compete as Cournot competitors, welfare-maximizing countries subsidize exports even if other exporting countries also subsidize their exports (non-cooperative Nash equilibrium) (see above n 2876).

[2879] Collie has shown that in *oligopolistic markets with Cournot competition*, exporting countries will usually be worse off if there is a trade war than under free trade, but that one country may be better off if its firm is very competitive relative to the other firm. Collie, above n 2876, 408-419; D. R. Collie, 'A Rationale for the WTO Prohibition on Export Subsidies: Strategic Export Subsidies and World Welfare', 11 *Open Economies Review* (2000), 229-245, at 235.

[2880] Also in models whereby *markets are competitive and export subsidies are inspired by political-economy considerations*, governments have an incentive to curtail such export subsidies. In general, curtailing export subsidies improves their terms of trade as well as the governments' budget (the latter also shows up in political-economy models). Grossman and Helpman have demonstrated why politicians motivated by self-interest would gain from concluding a trade agreement ('trade talk'). In this model, the benefits to politicians from concluding an agreement flow from the extra market access generated in third countries and from the reduction in government support for foreign firms competing in the import market for which they will be rewarded by export industries and import-competing industries respectively. G. M. Grossman and E. Helpman, 'Trade Wars and Trade Talks', *NBER Working Paper Series* No 4280 (February, 1993), 40 pp. In an alternative model elaborated in the full text, exporting countries which cooperate take into account the negative terms of trade effect on other exporters and are thus less likely to offer such subsidies. Bagwell and Staiger, above n 2871, at 177; see also Bagwell, above n 2836, at 28.

decide to stop subsidizing exports without its exporters losing sales (prisoner's dilemma), an important incentive among exporting countries for drafting multilateral disciplines exists.[2881] The same political-economy or strategic trade models that could clarify why countries subsidize in the first place could thus equally explain why countries agree to limit such subsidization multilaterally. To be clear, such a subsidy war among exporting countries in principle improves the welfare of net-importing countries as they benefit from a positive terms of trade effect. From a static welfare perspective, net-importing countries would indeed be hurt from an agreement prohibiting export subsidies. Still, net-importing countries could well be in favour of an agreement limiting export subsidies because of political-economy efforts by their import-competing industry[2882] or because foreign export subsidies inhibit the emergence of a domestic export industry (i.e., dynamic welfare argument).

As elaborated above, multilateral disciplines on curtailing export subsidies for non-agricultural products as well agricultural products mainly aimed at ending a (potential) subsidy war between (potential) exporting countries (positive theory perspective).[2883] At the same time, net-importing (developing) countries indeed raised concerns about the negative effects of limiting export subsidies[2884] but these were only taken seriously insofar they aligned to the interests of subsidizing countries that on political-economy grounds wished to continue subsidization, which was the case in the field of agriculture.[2885] The fact that agricultural export subsidies are not totally banned as of yet might indeed be explained on the basis of high political-economy pressure attached to them mainly in the EC,[2886] which might be insufficiently counteracted by political-economy efforts of import-competing industries (regarding domestic markets) or export-competing industries (regarding third markets) in other countries.[2887,2888]

[2880] Or of their exporters if present. See Bagwell, above n 2836, at 29.

[2881] Alternatively, the cooperative equilibrium could in theory be obtained in repeated games (tit-for-tat strategy).

[2882] Or, if present, of their exporters. See Bagwell, above n 2836, at 29.

[2883] See also G. C. Hufbauer and J. S. Erb, *Subsidies in International Trade* (Washington DC: Institute for International Economics, 1984), 283 pp., at 8-9.

[2884] On agricultural products, see Bagwell and Staiger, above n 2871, at 165-166. Regarding non-agricultural products, developing countries, for example, expressed concerns about the disciplines imposed by the OECD Arrangement on developed countries. These disciplines resulted in higher interest rates of export credits provided to their importers and therefore adversely affected their import opportunities. They requested the GATT Ministerial Meeting 'to address itself to the OECD Arrangement' and to recommend that the OECD Arrangement would not apply to exports of capital goods to developing countries. See Consultative Group of Eighteen, *Nineteenth Meeting of the Consultative Group of Eighteen* (CG 18/19, 26 July 1982), paras 36-37.

[2885] For instance, the preamble of the Agreement on Agriculture recognizes the possible negative impact of trade reforms on LDCs and net-food importing countries.

[2886] To be sure, these forces are also present in other countries (e.g., the US) with respect to 'indirect' forms of export subsidies (see above Part II, Chapter 1, Section 1.4; Part III, Chapter 7, Section 7.2.1).

[2887] On agricultural products, see Bagwell and Staiger, above n 2871, at 165-166. The EC's reluctance to cut export subsidies for agricultural products suggests that the EC gave more weight to political-economy considerations than the US did. Bagwell and Staiger, above n 2871, at 178-179. Gardner

In order to formalize the incentive to conclude multilateral disciplines on export subsidies (on agricultural products),[2889] Bagwell and Staiger have developed a three-country model. Two countries are exporting countries (A and B) and the third country is an importing country (C). Three different situations are distinguished. First, if countries do not cooperate, country A maximizes its welfare taking as given the subsidy policy of country B (Nash equilibrium). As explained in Part I, country A would not subsidize but tax exports if no political-economy considerations are present.[2890] Yet, if political-economy reasons are sufficiently high, country A would give an export subsidy in the non-cooperative Nash equilibrium, which would hurt country B and benefit country C. Put otherwise, country A would subsidize if more weight is given to the increase in producer welfare than to the negative effect on its terms of trade. Second, if both *exporting* countries would cooperate, country A would take the negative impact of the shift in the terms of trade on country B into account in its decision on subsidization, but would neglect the positive effects thereof on country C. As a consequence, country A would only subsidize if political-economy arguments outweigh the negative welfare effects on its own country as well as on country B. Hence, if exporting countries maximize welfare in a coordinative fashion, they would only subsidize if political-economy factors are very high. For a given level of political-economy considerations, exporting countries would subsidize less than under the first non-cooperative situation. This subsidy reduction would depress the positive welfare effects on country C. Third, if country A not only internalizes the negative impact on country B but also the positive impact on importing country C (i.e., maximizing total welfare), it would provide a so-called ‘efficient subsidy’ even if low political-economy considerations are present. Again, for a fixed political-economy factor, an ‘efficient subsidy’ would exceed the Nash subsidy (situation 1) which in turn would be higher than the cooperative subsidy (situation 2). Given that the level of subsidization is higher under the welfare-maximizing assumption (situation 3) than under the cooperative situation (situation 2), Bagwell and Staiger conclude that the world as a whole

explains in detail how the US export subsidies for wheat in the 1980s and first half of the 1990s should be understood as a response to the EC’s export subsidies demanded by influential agricultural special interest groups (wheat producers). By playing the ‘export subsidy game’ and thus matching EC export subsidies, the US government aimed at increasing the EC’s costs of their export subsidy programme and inducing the EC to agree upon limiting export subsidies in the Uruguay Round. The US legislation enacted in 1990 even included a ‘GATT trigger’, which required spending $1 billion on the Export Enhancement Program if no Uruguay Agreement had been reached by the end of June 1992. This indeed happened as the deadline was missed. See B. L. Gardner, ‘The Political Economy of US Export Subsidies for Wheat’, in A. O. Krueger (ed), *The Political Economy of American Trade Policy* (Chicago: The University of Chicago Press, 1996) 470 pp., 291-331.

[2888] World Trade Report 2006, above n 2725, at 190.

[2889] The model developed by Bagwell and Staiger focuses on agricultural negotiations but it is equally applied to non-agricultural negotiations. See, for example, Bagwell, above n 2836.

[2890] See above Part I, Chapter 1, Section 1.2.

may lose from an agreement restricting export subsidies.[2891] Therefore, these authors call into question 'the wisdom of GATT/WTO restrictions against export subsidies'.[2892] In their logic, an agreement improving world welfare would stimulate instead of prohibit export subsidies.[2893] In the analysis of Janow and Staiger, a basic dilemma is therefore present in an international trade agreement restricting export subsidies:

> The simple point is that the standard economic rationale for the purpose of negotiations over trade policy is that trade volumes are inefficiently low when governments set their trade policy unilaterally. As a consequence, from this perspective, the central task of trade negotiations is to expand trade volumes beyond their unilateral levels to more efficient levels. Since agreements to restrict export subsidies are agreements to restrict trade volumes below unilateral levels, such agreements appear to run counter to efficiency. Any economic argument in support of international agreements to restrict export subsidies must overcome this basic dilemma.[2894, 2895]

In Bagwell and Staiger's model, the welfare effect is influenced by a political-economy parameter. Indeed, their welfare (or efficiency) argument (i.e., normative argument) rests on the model's assumption of political-economy considerations. However, whereas political-economy reasons might very well explain *why* governments choose to subsidize exports and *why* exporting countries benefit from mutually lowering such export subsidies (i.e., positive theory perspective), incorporating such considerations seems to make their model less suitable for normative judgments on whether a government *should* be allowed to offer such subsidies (i.e., normative theory perspective).[2896,2897] In my view, political-economy considerations

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[2891] Their model suggests that cooperation between exporting countries 'indeed diminishes global efficiency'. Bagwell and Staiger, above n 2871, at 178; Bagwell, above n 2836, at 28.
[2892] Bagwell and Staiger, above n 2871, at 179.
[2893] Bagwell and Staiger, above n 2871, at 180. Bagwell also develops a two-country model whereby countries offer export subsidies on the basis of political-economy welfare functions. Because these countries do not internalize the positive terms of trade effect of these export subsidies on each other if they set subsidy levels unilaterally, they would 'achieve mutual gains though a trade agreement that *facilitates* a reciprocal increase in export subsidies'. Referring to both models (as well as to strategic trade models), Bagwell concludes that 'these models offer the normative implication that an efficiency-enhancing trade agreement should emphasize rules that facilitate trade expansion'. Bagwell, above n 2836, at 27-29.
[2894] See M. E. Janow and R. W. Staiger, 'Canada – Dairy, Canada – Measures Affecting the Importation of Dairy Products and the Exportation of Milk (WT/DS113; WT/DS103; DSR 1999:V, 2057, DSR 1999:VI, 2097; DSR 2001:XIII, 6829; DSR 2001:XIII, 6865; DSR 2003:I, 213; DSR 2003:I, 255)', in H. Horn and P. C.. Mavroidis (eds), *The American Law Institute Reporters' Studies on WTO Case Law – Legal and Economic Analysis* (Cambridge: Cambridge University Press, 2007), 249-292, at 264. This is also cited in Mavroidis, Messerlin, and Wauters, above n 2636, at 462. Janow and Staiger refer to Bagwell and Staiger, above n 2871, at 163-180.
[2895] According to Janow and Staiger, export-limiting agreements depress overall efficiency: 'they are good for the sellers, but not for the buyers, and not for the sellers and buyers on the whole' (Janow and Staiger, above n 2894, at 264). Yet, export subsidy restrictions are not welfare-improving for exporters ('sellers') but only for exporting countries (i.e., government budget and domestic consumers benefit).
[2896] Given the structure of the relevant chapter in Bagwell and Staiger's book, the model developed by Bagwell and Staiger at first sight seems to have been developed to explain the dynamism of reducing export subsidies (i.e., positive theory perspective). However, at the end of the chapter (and in other articles as well), the authors derive normative conclusions from their model. Bagwell even explicitly derives a normative conclusion from this model (see Bagwell, above n 2836). Green and Trebilcock also seem to criticize the latter paper for blurring positive and normative theory. See A. Green and M.

should indeed not be included in the definition of 'welfare' or 'efficiency' in models which aim to – or are used to – generate normative conclusions.[2898] As explained in Part I, under the perfectly competitive market assumption adopted in the Bagwell and Staiger model,[2899] global welfare is maximized if export subsidies are abolished, even though the rest of world and net-importing countries are hurt. If governments unilaterally set their trade policy, they do in practice offer export subsidies (in terms of the model, hereby indicating that political-economy arguments are sufficiently important). Yet, this leads to an *inefficienlyt high* level of trade: international trade is distorted because output is above and prices are below the free trade level.[2900] Bagwell draws a parallel between their model and the strategic trade literature.[2901] Yet, a fundamental difference between the Bagwell and Staiger model and strategic trade models is that output is indeed *inefficiently low* in oligipolistic markets and that export subsidy competition between exporting countries (i.e., non-cooperative Nash equilibrium) could therefore be globally welfare-improving as it brings output closer to the perfect competition level.[2902,2903] Hence, a prohibition on export subsidies in such markets does indeed not only hurt importing countries but could also be welfare-reducing from a global perspective.[2904] However, Collie has shown that if governments' opportunity costs of funds used to pay for the subsidies are sufficiently high, global welfare would again be improved when export subsidies are prohibited in oligopolistic markets.[2905] Of course,

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Trebilcock, 'Enforcing WTO Obligations: What Can We Learn from Export Subsidies?', 10:3 *Journal of International Economic Law* (2007), 653-683, at 662-663.

2897 See also above Part I, Chapter 3, Section 3.4.

2898 Recall that the normative objective is, as Adam Smith has put it, to maximize global welfare.

2899 Bagwell and Staiger, above n 2871, at 169.

2900 According to Bagwell and Staiger, 'rules that (…) facilitate a reduction in trade volume warrant special scrutiny'. Bagwell and Staiger, above n 2871, at 180.

2901 Bagwell and Staiger also differentiate their model from strategic trade models but not on this important element. Bagwell and Staiger, above n 2871, at 168, 178-179; Bagwell, above n 2836, at 28-29.

2902 In an oligopolistic setting, the analogy drawn by Bagwell with anti-trust policy seems to be more valid. In this analogy, sellers of a given product are the exporting countries and consumers are the importing countries. According to Bagwell, restrictions on the use of export subsidies may represent a victory for exporting countries that comes at the expense of the 'importing government and world-welfare'. Bagwell, above n 2836, at 28. While the analysis regarding exporting and importing countries holds regardless of the market type, such a 'cartel' among exporting countries only comes at the expense of world welfare in an oligopolistic market and not in competitive markets.

2903 Bagwell and Mavroidis also point to the similarity to the market being distorted by an import tariff. Hence, 'an appropriate export subsidy could offset the import tariff and result in a more efficient trade volume' (Bagwell and Mavroidis, above n 2911, at 169, footnote 252). However, this valid point is respected under the SCM Agreement given that rebates of import duties on exported products are not considered subsidies under the SCM Agreement and are thus not disciplined.

2904 Collie, above n 2879, at 230; D. Leahy and J. P. Neary, 'Multilateral Subsidy Games', 41:1 *Economic Theory* (October, 2009), 41-66, at 2; J. A. Brander, 'Strategic Trade Policy', in G. M. Grossman and K. Rogoff (eds) *Handbook of International Economics – Volume 3* (Amsterdam: North-Holland, 1995), 1395-1455, at 1409; J. Eaton and G. M. Grossman, 'Optimal Trade and Industrial Policy under Oligopoly', 101:2 *The Quarterly Journal of Economics* (May, 1986), 383-406, at 396.

2905 Collie shows that for certain values of opportunity costs of funding, these 'costs' are sufficiently low to explain why exporting countries nonetheless benefit from subsidizing in the non-cooperative importing countries are still at the losing end from a static welfare perspective in case export subsidies are abolished. In sum, I fundamentally disagree with Bagwell and Staiger's conclusion that the world as a whole would lose from a prohibition on export subsidies in competitive markets. Their conclusion seems to result form a confusion of positive and normative theory. Only in the case of oligopolistic markets could a prohibition on export subsidies be considered world welfare-reducing under certain conditions.

Drawing a clear distinction between positive and normative theory regarding the prohibition on export subsidies offers straightforward but interesting insights.

Positive theory demonstrates that political-economy as well as strategic trade arguments could explain *why* countries start offering export subsidizing, *why* other exporting countries equally reply with export subsidies, and *why* those countries finally have an incentive to conclude a trade agreement ending such destructive subsidy war.[2906] Grossman and Mavroidis have found evidence in the provisions of the SCM Agreement that its purpose is indeed to protect producer welfare, suggesting that countries are driven by political-economy motivations when concluding trade agreements.[2907] Or, in the words of Mavroidis et al, the SCM Agreement is driven by a common will of 'promoting (short-term) producers' interests only'.[2908]

From a normative perspective, however, an agreement prohibiting export subsidies could only be criticized in strategic trade settings in which, under certain conditions (e.g., opportunity costs of funds are not too high), such a ban would be world welfare-reducing. Yet, an important implication from positive theory is that even if multilateral WTO disciplines would take this normative viewpoint on board and allow export subsidies under those conditions, exporting countries would still have the same incentive to agree among themselves in another setting to curtail such export subsidies.[2909] Even in the absence of a binding legal agreement, repeated interaction among exporting countries could lead towards the non-subsidy equilibrium ('tit-for-tat' strategy), as demonstrated by the non-binding OECD Arrangement

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Nash equilibrium, but are, on the other hand, sufficiently high to explain why global welfare would be better off by prohibiting such subsidies. D. R. Collie, 'A Rationale for the WTO Prohibition on Export Subsidies: Strategic Export Subsidies and World Welfare', 11 *Open Economies Review* (2000), 229-245.

[2906] Destructive from the perspective of those exporting countries.

[2907] Because the disciplines on CVDs do not distinguish between situations where such CVDs would be welfare-improving from the perspective of the CVDs-imposing country (e.g., strategic trade settings) and other situations. Grossman and Mavroidis, 'Here Today, Gone Tomorrow?', above n 2666, at 199.

[2908] Mavroidis, Messerlin, and Wauters, above n 2636, at 298. See also P. C. Mavroidis, 'Come Together? Producer Welfare, Consumer Welfare and WTO Rules', in E-U. Petersmann (ed), *Reforming the World Trading System - Legitimacy, Efficiency, and Democratic Governance* (Oxford: Oxford University Press, 2005), 590 pp., 277-289, at 287.

[2909] For instance, the Bagwell and Staiger model precisely shows that exporting countries have an incentive to conclude an agreement limiting export subsidies. This incentive likewise exists in strategic trade settings.

on limiting export credit support.[2910] Hence, reintroducing more flexibility on export subsidies, as authors like Bagwell, Staiger, and Mavroidis and also Sykes in his most recent writings seem to propose,[2911] might not even lead to a significant increase in export subsidies.[2912] From a normative perspective, the intricacy of translating the conditions under which export subsidies improve world welfare into a limited legal exception[2913] as well as the

[2910] See above Part III, Chapters 2 and 3. J. A. Brander, 'Rationales for Strategic Trade and Industrial Policy', in P. Krugman (ed), *Strategic Trade Policy and the New International Economics* (Cambridge: The MIT Press, 1986), 23-46, at 39.

[2911] In previous writings, Sykes reached the conclusion that 'from an economic standpoint, export subsidies are generally undesirable' and that the SCM Agreement includes 'a sensible prohibition on export subsidies', which could even be 'usefully extended to agriculture and services sectors'. But in his most recent contribution, Sykes has apparently changed his opinion as he reached the conclusion that:

> 'Export subsidies are assuredly a mixed bag from a welfare standpoint. An across the board prohibition on them seems difficult to defend, however, unless one is prepared to assume (a) that export subsidies are on average welfare-reducing; and (b) tailored rules to sort the good from the bad are too difficult to devise. Although assumption (b) is plausible, the empirical basis for (a) is not evident'.

Sykes' general conclusion in the latter article holds that the laissez-faire approach to subsidies in the US system might make more sense than the WTO (and EC) approach. On the other hand, Bagwell and Mavroidis seem to suggest undoing the prohibition on export subsidies and disciplining all types of subsidies (including export subsidies) only on the basis on the non-violation complaint. In their words, 'keeping NVC as the sole response to subsidies (beyond imposition of countervailing duties, CVD) is an adequate response'. However, it is hard to imagine how a non-violation complaint could impose *any* discipline at all on export subsidies as such claim holds that the benefit of a tariff concession – which occurs in the domestic market – is neutralized by a subsequent subsidy. An export subsidy, which increases the price in the domestic market, could by definition not cause such effect. Hence, the non-violation complaint as currently drafted would impose no discipline at all on export subsidies. Compare with Sykes, above n 2661, at 90-92, 106; Sykes, above n 2635, at 36-37, 39; K. W. Bagwell and P. C. Mavroidis, 'Too Much, Too Little…Too Late', in K. W. Bagwell, G. A. Bermann, and P. C. Mavroidis (eds), *Law and Economics of Contingent Protection in International Trade* (Cambridge: Cambridge University Press, 2010), 168-171.

[2912] Admittedly, the fact that the OECD Arrangement is still more flexible than the general export subsidy prohibition in the SCM Agreement shows that Participants to the OECD Arrangement have an incentive to curtail export subsidies but this did not yet result in a ban of support at better-than-market terms. This is partly explained on the basis of the gap in the private trade finance market. The more flexible standard also implies that exporters are *de jure* put on an equal footing, but those exporters *de facto* receiving support are still given a competitive advantage over exporters (or domestic producers) which do not get export credit support (or other support) from their government. Moreover, the standard in the OECD Arrangement is drafted in such a way that it is *de facto* more flexible for developed countries.

[2913] For example, Collie has shown that world welfare would be depressed only if the opportunity costs of government funds is not too high (see above n 2905), which refers to an aspect that could obviously not be reflected in multilateral rules. Recognizing that imperfectly competitive goods tend to be underprovided from the perspective of world welfare, Brander also observed that 'decentralized strategic trade policies will not, except by remarkable coincidence, achieve outcomes that approach the world-level normative ideal, suggesting that international trade policy coordination should act as an important restraint on nationally-determined strategic trade policies'. Given the difficulty in implementation, Mavroidis et al likewise seem to suggest that the best policy might be not to act except when all information is available. Lastly, Eaton and Grossman have demonstrated that investment subsidies are more likely to be welfare-improving instruments in strategic settings than export (or output) subsidies, which might justify more restrictive disciplines on export subsidies. J. A. Brander, 'Strategic Trade Policy', in G. M. Grossman and K. Rogoff (eds), *Handbook of International Economics – Volume 3* (Amsterdam: North-Holland, 1995), 1395-1455, at 1448; Mavroidis, Messerlin, and Wauters, above n 2636, at 295. Tangermann also highlights the practical difficulties to draft a limited exception. See S. Tangermann, 'Approaches to Export Subsidies: Disciplines for Export fact that under most circumstances export subsidies depress world welfare also support a simple rule prohibiting export subsidies.[2914] In addition, from a dynamic welfare stance, the prohibition is helpful to (potential) exporters in developing countries as these countries have less leverage to match foreign subsidies.[2915] Therefore, the general world welfare-depressing effect of export subsidies legitimizes a simple prohibition on such subsidization, even if world welfare is not the main motivation to install such a prohibition in the first place (i.e., positive theory perspective).[2916] Although several scholars would thus disagree with this conclusion, others concur that the ban on export subsidies indeed makes sense from a normative viewpoint.[2917] The welfare benefits are captured by the subsidizing exporting countries and those benefits outweigh the costs of such prohibition to net-importing countries. In non-strategic settings, the multilateral prohibition therefore allows governments to implement a welfare-superior policy which it might apparently not reach in a unilateral setting because of pressure of special interest groups.[2918] Accordingly, the normative welfare-argument for prohibiting export subsidies corresponds to a so-called 'tie your own hands'-argument. As Messerlin observes, WTO disciplines could enhance the domestic or internal sovereignty of its Members, whereby he refers to their capacity to resist powerful domestic special interest groups.[2919] According to this author, the fact that WTO disciplines could help governments to resist pressure from special interest groups is an aspect that policy space supporters

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Subsidies in Primary and Non-Primary Products – Should There be Different Disciplines for Export Subsidies on Primary and Non-primary Products?', in B. Balassa (ed), *Subsidies and Countervailing Measures – Critical Issues for the Uruguay Round* (Washington: The World Bank, 1989), 104-121, at 109-110.

[2914] An exception could be made in case market failures relate to export markets (see above case study on export credit support; Part III) and export subsidies are thus a first-best corrective instrument.

[2915] This was already recognized by India during the 1954-1955 Review Session of the GATT.

[2916] A parallel could be drawn with tariff negotiations. Tariff reductions are also seen as a cost in political-economy terms, which has to be paid in exchange for foreign reductions in bound tariff levels. Yet, they represent a gain in welfare terms to the committing country, unless the optimal tariff exception applies.

[2917] Green and Trebilcock concluded that 'export subsidies (…) appear on balance to be globally inefficient'. Likewise, Barceló found that 'a universal ban on export subsidies would raise world welfare'. As noted above, Sykes also considered in previous writings that the ban on export subsidies is justified economically (see above n 2911). Green and Trebilcock, above n 2896, at 660-662; J. J. Barceló, 'Subsidies and Countervailing Duties – Analysis and Proposal', in R. Howse (ed), *The World Trading System: Critical Perspectives on the World Economy – Volume 3 – Administered Protection* (London: Routledge, 1997), 252-314, at 264; see also Hufbauer and Erb, above n 2883, at 8.

[2918] In strategic settings, the unilateral incentive to offer subsidies could be inspired by welfare considerations (i.e., profit-shifting export subsidies).

[2919] He made this observation by giving the example of 'binding' tariffs. P. A. Messerlin, 'Three Variations on "The Future of the WTO"', 8:2 *Journal of International Economic Law* (2005), 299-309; P. A. Messerlin, 'Enlarging the Vision for Trade Policy Space: Special and Differentiated Treatment and Infant Industry Issues', *The World Economy* (2006), 1359-1407. Noticing the limited potential benefits of interventions, Krugman concludes that 'free trade can serve as a focal point on which countries can agree to avoid trade wars. It can also serve as a simple principle with which to resist pressures of special-interest politics'. P. R. Krugman, 'Is Free Trade Passé?', 1:2 *The Journal of Economic Perspectives* (Fall, 1987), 131-144, at 144.

systematically neglect.[2920] In my opinion, this is also an aspect that the normative conclusion derived by Bagwell and Staiger from their model overlooks.[2921] Precisely because of this 'tie your own hands'-argument, Finger and Winters criticize the exemptions on subsidy disciplines for low-income countries as it implies that the agreement offers 'virtually no cover against lobbies seeking subsidies'.[2922] They thus present a normative argument why export subsidization of 'small countries' should nonetheless be restricted in a multilateral framework even though such subsidies do not affect the terms of trade.[2923] We return to this argument in discussing the policy space left for developing countries.

In sum, the prohibition on export subsidies would enable exporting countries to resist special interest groups and these welfare benefits outweigh the costs of such a prohibition to net-importing countries in competitive markets.[2924] From a normative perspective, the costs upon net-importing countries do therefore not justify an exemption on export subsidies. If countries would aim to consider the distributional consequences of such a prohibition, compensating net-importing countries by lump-sum transfers would be superior as this would not distort trade flows. For example, the cost on net-food importing countries of implementing a general prohibition on agricultural export subsidies would in theory be better compensated by lump-sum transfers (e.g., development aid, Aid for Trade, in-cash food aid). Such development aid offers developing countries the option to subsidize imports of food and source it from the most efficient exporter (or invest in own food production), which not necessarily corresponds to the country previously subsidizing its exports. Because such transition from direct or indirect export subsidies to genuine development aid might take some time, the adverse effects on net-food importing countries could warrant that the abolition of such export subsidies on agricultural subsidies should not be implemented overnight.

But could a straightforward ban on export subsidies be justified in light of the fact that another trade instrument, namely a tariff, is still allowed up to its bound level? Wondering about this difference in disciplines, Baldwin pointed to the apparent general conviction that

[2920] P. Messerlin, 'Enlarging the Vision for Trade Policy Space: Special and Differentiated Treatment and Infant Industry Issue', above n 2919, at 1402.

[2921] See Bagwell, above n 2836, footnote 41. Janow and Staiger also refer to this 'tie your own hands'-rationale (Janow and Staiger, above n 2894, at 260-261).

[2922] M. J. Finger and L. A. Winters, 'What Can the WTO Do for Developing Countries?', in A. O. Krueger (ed), *The WTO as an International Organization* (Chicago: The University of Chicago Press, 1998), 425 pp., 365-392, at 387.

[2923] Because terms of trade are not affected, other countries would not be interested in restricting subsidization of small countries (i.e., positive theory perspective). This is partly reflected in the S&D treatment provisions (e.g., export performance criteria).

[2924] This would also be the result in oligopolistic markets in case the opportunity cost of funds is relatively high (above n 2905).

'domestic producers are somewhat more entitled to domestic compared to foreign markets'.[2925] But according to Bagwell, the terms of trade agreements theory suggests that export subsidies *should* be treated with greater leniency than tariffs.[2926] At first sight, this systemic argument against the prohibition on export subsidies seems plausible given that the rest of the world benefits from a terms of trade improvement in case of export subsidies, whereas it is hurt by such an effect in case of tariffs. Yet, from a global welfare perspective, both should simply be abandoned under the perfect market assumption and the fact that tariffs are given more leeway does not support the argument to give the same leeway to export subsidies. Such a prohibition on export subsidies does also not bear the risk that countries would turn to increased tariff levels because the offensive interests of exporters in third-markets can simply not be protected with tariffs.[2927] Somewhat contrary, Kenen has suggested that one of the rationales for disciplining export subsidies was exactly to safeguard tariff negotiations. When governments offer tariff concessions (which have a political-economy cost), they expect that they can still protect their import-competing industry up to the bound level of the reduced tariff. If this bound level could be eroded by export subsidies given by third countries, the effective level of protection could not be maintained.[2928] Hence, this rationale for the prohibition of export subsidies acknowledges that cutting tariffs has a cost in political-economy terms and that tariff negotiations would be undermined if the bound tariff levels could subsequently be circumvented by the provision of export subsidies. This systemic argument could offer an additional rationale for prohibiting export subsidies (of large countries) from a positive as well as normative point of view.[2929]

[2925] R. E. Baldwin, 'The Economics of the GATT', in P. Oppenheimer (ed), *Issues in International Economics* (London: Oriel Press, 1978), 82-93, at 86. Balassa also referred to this asymmetry. B. Balassa, 'Subsidies and Countervailing Measures: Economic Considerations', in B. Balassa (ed), *Subsidies and Countervailing Measures – Critical Issues for the Uruguay Round* (Washington: The World Bank, 1989), 28-45, at 29.

[2926] K. Bagwell, above n 2836, at 30; see also Bagwell and Mavroidis, above n 2911, at 170. According to Messerlin, however, the ranking of the instruments of protection in the GATT, whereby tariffs are preferred to other border barriers such as quantitative restrictions or export subsidies, 'is broadly consistent with the welfare balances that trade policy analysis associates with these trade instruments'. P. Messerlin, Non-Discrimination, 'Welfare Balances and WTO Rules: An Historical Perspective', in E-U. Petersmann (ed), *Reforming the World Trading System – Legitimacy, Efficiency, and Democratic Governance* (Oxford: Oxford University Press, 2005), 590 pp., 291-303, at 295.

[2927] Notice that Bagwell does also not argue that the prohibition on *export* subsidies could have a chilling effect on tariff negotiations. Such an argument is made for disciplines on *domestic* subsidies (see above Part IV, Chapter 2, Section 2.1.2).

[2928] For example, if the US cuts its tariff on imported steel to 10 per cent (bound and applied level), other countries could still enter the US at free trade price if they offer a 10 per cent export subsidy to their steel industry. P. Kenen as cited in A. O. Sykes, 'Countervailing Duty Law: An Economic Perspective', 89 *Columbia Law Review* (March, 1989), 199-262, at 261; Sykes, above n 2635, at 36.

[2929] Strictly speaking, a ban on export subsidies is however not required given that the allowance to impose CVDs, which could be added on top of bound tariff levels, would in principle be sufficient to safeguard tariff levels. See below on the systemic justification for CVDs, Part IV, Chapter 4, Section 4.2.2.

This discussion on the normative rationale underpinning a prohibition on export subsidies has largely neglected the market failure argument for offering export subsidies. Still, this is no oblivion as export subsidies are generally not first-best instruments to correct market failures in developed countries because these failures are mostly domestic in nature (targeting principle).[2930] After all, production subsidies would always be superior to correct domestic market failures given they do not involve a cost to domestic consumers. As a result, the market failure rationale can *as such* not explain why export subsidies are offered (i.e., positive theory perspective) and the presence of such market failures can also not justify the need for developed countries to have leeway to offer such export subsidies (i.e., normative theory perspective). Furthermore, the market failure argument can neither explain nor legitimize the different treatment of agricultural export subsidies currently stipulated under the Agreement on Agriculture.[2931] Hence, the Doha Round agreement to gradually phase-out these export subsidies for agricultural products (normally by 2013) should be endorsed, though its implementation is of course dependent on the successful conclusion of this Round. As discussed in Part III, a limited exception on the principle prohibition of export subsidies could be made in case market failures occur in exporting markets (e.g., rationale for export credit support), though it would in theory be more efficient if such export credit support would be offered by international institutions. Moreover, as discussed in the following section, export subsidies might be a useful development tool to overcome certain market failures in developing countries.

[2930] See, for example, R. Howse and M. Trebilcock, *The Regulation of International Trade*, 3rd ed (UK: Routledge, 2005), 759 pp., at 276; Schwartz and Harper, above 2659, at 835.
[2931] The multifunctionality argument could at most legitimize some types of domestic support but can certainly not legitimize subsidies contingent upon exportation. See also, Tangermann, above n 2913, at 111-114; A. Dunkel, *Trade Policies for a Better Future – The 'Leutwiler Report', the GATT and the Uruguay Round* (Dordrecht: Martinus Nijhoff Publishers, 1987), 7-69, at 47.

3. DISCIPLINES ON SUBSIDIZATION BY DEVELOPING COUNTRIES

3.1. DISCIPLINES ON DOMESTIC SUBSIDIES

3.1.1. The prohibition on local content subsidies

One type of domestic subsidies is simply prohibited under the SCM Agreement: subsidies contingent upon the use of domestic over imported inputs (Article 3.1(b) of the SCM Agreement). The *US – Upland Cotton* case has revealed that this prohibition on local content subsidies is likewise applicable with regard to agricultural products.

Developing countries enjoyed temporal flexibility on this prohibition, but this S&D treatment has expired by now (Article 27.3 of the SCM Agreement). Often, such local content requirements were put in place as a condition to benefit from subsidization in export processing zones (EPZs). The strategy was to attract foreign direct investment (FDI) through subsidization (e.g., rebates on direct taxes) and to ensure at the same time that a viable domestic upstream industry would further develop, for example through knowledge spillovers. Overall, empirical evidence has shown that such local content requirements are not conductive for spurring economic growth, because these restrictive policies are unlikely to generate intra-industry spillovers.[2932] Therefore, the prohibition to make subsidies contingent upon local content seems not problematic. Obviously, developing countries could still spur the development of the domestic input industry by subsidizing this industry directly. Such a subsidy would not be prohibited but would be covered under the general disciplines on domestic subsidies, to which we turn in the next section.

3.1.2. Disciplines on all other types of domestic subsidies

In contrast to the S&D treatment on export subsidies, S&D treatment on actionable subsidies does not differentiate between developing countries according to their income level but is similarly available to all developing countries.[2933] However, the analysis in Part II revealed that the substance of their policy flexibility to offer such subsidies is not entirely clear. Surely, other WTO Members can take multilateral action against subsidization causing injury to their *domestic industry* as well as against *nullification or impairment of tariff concessions* or other GATT obligations (Article 27.9 of the SCM Agreement). Yet, no definitive answer exists on whether a *serious prejudice* claim could also be formulated against some types of subsidies (i.e., subsidies listed in Article 6.1. of the SCM Agreement). I would expect that a future panel confronted with this question would rather opt for a restrictive reading of Article 27.9 of the SCM Agreement that would exclude such type of claim. Taking a normative

[2932] See above Part I, Chapter 2, Section 2.4.4.
[2933] Except for China.

perspective, a narrow reading of this Article 27.9 could be welcomed in light of the importance of subsidies to correct market failures as well as the risk that too stringent subsidy disciplines could undermine tariff negotiations (i.e., systemic argument).

First, the success of outward-oriented development strategies has shown that substantive leeway for subsidization is important in the presence of market failures impeding economic growth and diversification (e.g., inducing self-discovery, overcoming coordination failures). Admittedly, even under the broad interpretation of Article 27.9 of the SCM Agreement, a substantive part of domestic subsidies aiming at correcting market failures would not be vulnerable to a challenge on the basis of 'serious prejudice' because such challenge would only be allowed for those types of subsidies listed in Article 6.1 of the SCM Agreement.[2934] Regardless of their nature, subsidies exceeding the threshold of 5% total ad valorem in terms of the cost to the government would be vulnerable to a serious prejudice claim.[2935] The other types of measures listed in Article 6.1 of the SCM Agreement mainly target subsidies to enterprises or industries in difficulties. While one might suggest that these other types of subsidies are generally considered not justified on economic grounds, temporary subsidization of enterprises having a dominant position in an undiversified market might still be needed (i.e., congestion argument).

Second, as Bagwell and Staiger have explained,[2936] the supremacy of subsidies over tariffs to correct domestic market failures carries the risk that overly stringent subsidy disciplines would hamper tariff negotiations. Such a 'chilling effect' would be present if developing countries would be reluctant to cut their tariff levels because their potential subsidies could be challenged before the WTO. This would be detrimental from the perspective of both the subsidizing developing country as well as other countries. For instance, a developing country might be resistant to reduce its bound tariff levels if it is aware that subsidies granted to firms in difficulties would be challengeable. The options given under the restrictive reading of Article 27.9 to formulate a non-violation complaint as well as a complaint on the basis of injury to the domestic injury (which is the multilateral alternative of unilateral CVDs) would exactly safeguard further tariff negotiations. Indeed, the first instrument would ensure that other WTO Members could effectively benefit from tariff reductions made by the subsidizing developing country, whereas the presence of the latter option could, in theory, make it credible to import-competing industries that bound tariff levels will not be eroded by foreign subsidization.

[2934] Recall also that only 'selective' domestic subsidies are disciplined (Article 2 of the SCM Agreement) and that such serious prejudice claim would also be dependent on the successful demonstration of trade effects (Article 6.3 of the SCM Agreement).
[2935] See, for example, Panel Report, *Indonesia – Autos*.
[2936] See above Part IV, Chapter 2, Section 2.1.2.

Importantly, the S&D treatment on domestic (and export) subsidies partly shields developing countries from multilateral claims before the WTO dispute settlement system but does not preclude unilateral CVDs action taken by other WTO Members. Article 27.10 of the SCM Agreement only increases the general *de minimis* standard in case such CVDs action is considered against developing countries' subsidized imports. Analyzing the potential for such CVDs action from a normative perspective, it seems that both the market failure rationale underpinning the case for subsidization and the systemic argument point in different directions.[2937] On the one hand, the market failure rationale suggests that CVDs action against corrective subsidization could not be justified as it might target 'fair' subsidization. The imposition of CVDs is at odds with the explicit recognition in the SCM Agreement that 'subsidies may play an important role in economic development programmes of developing countries'.[2938] On the other hand, CVDs could play a useful role to safeguard tariff negotiations because they provide importing countries with an instrument ensuring that their bound tariff levels will not be eroded.[2939] Yet, two arguments cast doubt on whether great importance should be attached to the latter justification. Firstly, the large majority of CVDs is imposed by a small group of developed countries (i.e., US, EC, and Canada) upon some industrial products. Given that these countries already have very low levels of bound tariffs on industrial products, restricting the scope for CVDs action would likely not significantly hamper further tariff cuts. Secondly, the multilateral option to challenge domestic subsidies when causing injury to an import-competing domestic industry would in principle offer a less trade-distortive alternative than unilateral CVDs actions, even though I admit that the time-consuming multilateral option will not be considered equally effective by import-competing industries. On balance, the value of subsidies as a corrective development tool and the trade-distortive impact of (a threat of) CVDs actions, which in practice predominantly target developing countries' imports, would justify further increasing the *de minimis* threshold for taking CVDs action against developing countries' imports along the lines suggested by India in the Doha Round.[2940]

Given that domestic subsidies for industrial products offered by developing countries thus still remain countervailable and actionable under some circumstances, the reinstallation of a kind of green light category of domestic subsidies would effectively offer some more policy space

[2937] See also below, Part IV, Chapter 4, Section 4.1.2.
[2938] Article 27.1 of the SCM Agreement.
[2939] This will be labelled the systemic rationale for justifying CVDs action in a multilateral trade agreement. CVDs would allow governments to make a credible commitment to their import-competing industries that bound levels will be respected. This would make it more feasible in political-economy terms to agree upon multilateral tariff reductions.
[2940] As explained in Part II (Chapter 6, Section 6.1.3), India has introduced such a proposal in the Doha Round. This is not surprising given that India has been the main target of such CVDs action.

to developing countries.[2941] Hoekman et al have formulated such a proposal for the reactivation of the green light status of R&D subsidies with respect to developing countries.[2942] In particular, flexibility has to be given to tackle information externalities inhibiting self-discovery as suggested by Hausmann and Rodrik.[2943] To be precise, Hoekman et al's reasoning does not assume the mere reactivation of the R&D subsidies carve-out as in its current form stipulated in Article 8 of the SCM Agreement because this only gave leeway to assistance for research aiming at inventing and developing *new* products and processes (i.e., on-the-frontier innovations).[2944] Instead, assistance promoting self-discovery aims at supporting firms to discover which existing products could be produced domestically at competitive prices (i.e., inside-the-frontier innovations).[2945] While making an argument for policy space in order for developing countries to be able to induce self-discovery, Hoekman et al do not support complete policy freedom because multilateral disciplines could be useful to prevent capture by private interests and enhance the credibility of exit mechanisms. They launch the idea to 'adopt monitoring and surveillance mechanisms in the WTO that are aimed at increasing information on the effect and effectiveness of policies that aim at encouraging innovation'.[2946] Rightly in my view, substantive legal policy constraints seem not to be proposed. Increased notification and 'soft' surveillance might indeed temper the risk of government failures without undermining the need for policy space to use such subsidies as a development tool. Yet, such improved international surveillance could only be set-up if the carve-out also places subsidization outside the reach of potential CVDs action by trading partners.

Finally turning to agricultural domestic subsidies, Hoekman et al have advocated the rebalancing of the rights for developing countries to support their agricultural sector. They

[2941] Recall that non-actionable subsidies were still challengeable under certain limited conditions. Interestingly, the systemic concern formulated by Bagwell and Staiger would warrant that fully excluding such subsidies from any potential actionable subsidy claim (i.e., non-violation claim or injury to domestic industry claim) could likewise have a detrimental effect on tariff negotiations because trading partners would no longer be sure that subsidization will not erode tariff concessions.
[2942] In the Doha Round, Venezuela and Cuba also formally proposed the reinstallation of the green light non-actionable subsidies because of their importance as development tool. See *Improved rules under the Agreement on Subsidies and Countervailing Measure – Non-actionable subsidies* (TN/RL/41/Rev.1, 10 March 2003).
[2943] Yet, Hoekman et al do not specify the criteria to be used to differentiate such S&D treatment between developing countries. B. M. Hoekman, K. E. Maskus, K. Saggi, 'Transfer of Technology to Developing Countries: Unilateral and Multilateral Policy Options', *IBS Research Program on Political and Economic Change, Working Paper PEC 2004-2003* (May, 2004), 34 pp., at 22-23.
[2944] As elaborated above (Part II, Chapter 4, Section 4.3), assistance was allowed for covering part of the cost of 'industrial research'. This aimed at discovering new knowledge that could be useful for developing new products, processes, or services. Moreover, the cost of 'pre-competitive development activities', which build upon such industrial research findings, was also covered.
[2945] See above Part I, Chapter 2, Section 2.4.2.1.
[2946] See Hoekman, Maskus, and Saggi, above n 2943, at 22-23.

highlight that such support will often not qualify as permitted 'green box' support because this box does not address the types of market failures often found in these countries.[2947] Here, one should not forget that developing countries do have certain policy space to offer such support under existing disciplines.[2948] Next to support under the S&D box, all developing countries could offer *de minimis* levels (10 per cent) of (non-)product-specific support and, in theory, provide blue box support as well.[2949] Moreover, developing countries that had non-exempted subsidies in place during the Uruguay Round are allowed to offer an additional level of amber box subsidies up to their reduction commitment levels. The S&D treatment of developing countries under the SCM Agreement might also render it unlikely that these subsidies would effectively be challenged as actionable subsidies under the SCM Agreement, even though such claims as well as CVDs action are not excluded.

3.2. DISCIPLINES ON EXPORT SUBSIDIES

3.2.1. Policy space given to some developing countries to offer export subsidies

As documented in depth in Part I, two general arguments underpinning the need for policy space to subsidize exports in developing countries could be distinguished.[2950] First, evidence that exporting firms are relatively more productive suggests that it might be appropriate to link subsidization aimed at overcoming market failures to export performance (i.e., carrot-and-stick rationale), certainly because market failures are often considered relatively more prevalent in the trading sector. This explains why even trade-skeptics such as Rodrik are in favour of export subsidies in order to overcome market failures related to discovery or clustering. Second, the finding of a learning-by-exportation effect, often combined with the assumption that such learning spills over to other segments of the economy, provides an alternative justification for subsidizing exports (i.e., productivity improvement rationale).

[2947] They list a number of subsidy interventions that should be allowed: (i) product-specific as well as general investment and input subsidies or other supports to households below the national poverty line in order to encourage agricultural and rural development; (ii) programmes that support product diversification in small, low income developing countries currently dependent on a very small number of commodities for their exports, including programmes involving government assistance for risk management; (iii) foodstuffs at subsidized prices aimed at meeting food requirements of the poor, which might for administrative reasons be best provided via producer subsidies (food security); (iv) transportation subsidies for agricultural products and farm inputs to poor remote areas; (v) programmes involving government assistance for the establishment of agricultural cooperatives or other institutions that promote marketing, quality control or otherwise strengthen the competitiveness of poor farmers. See Hoekman, C. Michalopoulos, and L. A. Winters, 'More favourable and differential treatment of developing countries: towards a new approach in the WTO', *World Bank Policy Research Working Paper* No. 3107 (August 2003), 30 pp., at 20-21.

[2948] Thus, their conclusion that producer subsidies are generally not allowed because developing countries did not register subsidies during the Uruguay Round and 'are bound by a commitment not to increase subsidies above historical levels' seems too restrictive. Hoekman, Michalopoulos, and Winters, above n 2947, footnote 23.

[2949] India, for example, has relied upon such blue box support.

[2950] See above Part I, Chapter 2, Section 2.4.3.2.

This exactly explains the World Bank's recent plea for proactive policies in developing countries to support trade and export (diversification) in particular. It seems that the World Bank thus no longer questions that selective and functional government interventions might be needed to spur export diversification hampered by serious market failures, whereby the optimal strategy depends on the specific characteristics of each country ('one size does not fit all').[2951] Already during the Uruguay Round, India underscored the need for policy space on export subsidies by referring to the prevalence of distortions in the domestic market:

> These distortions are caused inter alia by inadequate exploitation of economies of scale, factor market imperfections, underdeveloped infrastructure, high cost of inputs, fragmented capital markets, inadequate foreign-exchange market and poor marketing infrastructure. Subsidies therefore become necessary to compensate the industry or the exporter for such distortions. In some cases, because of paucity of resources, developing countries have to limit their corrective measures to the export sector only.[2952]

Hereby, the option to focalize on the export sector might exactly be justified on the basis of the carrot-and-stick and/or productivity improvement rationales.[2953] Moreover, India considered these subsidies warranted because they compensate for higher costs due to the relatively higher prevalence of such distortions in developing countries. As such, they would merely 'level the playing field' with exporters from more developed countries.[2954]

At present, only a subset of all developing countries still benefits from S&D treatment on export subsidies. Two different groups of developing countries should be distinguished. First, policy space to offer whatever type of export subsidy is offered to LDCs and those low-income countries listed in Annex VII(b) that have not reached the level of $1,000 GNP per capita (in constant 1990 dollars) for three consecutive years. Generally speaking, this

[2951] Recall that the Report of the Growth Commission also considered that developing countries may need policy space 'to promote their exports until their economies have matured and their competitive position has improved'. Commission on Growth and Development, *The Growth Report – Strategies for Sustained Growth and Inclusive Development* (Washington DC: The World Bank, 2008), 190 pp., at 11.

[2952] *Submission by India, Elements of the framework for negotiations* (MTN.GNG/NG10/W/33, 30 November 1989), para 7.

[2953] In response to the US proposal in the Doha Round to limit policy space on export subsidies, India also referred to the need for such policy space because of learning-by-exporting effects: 'Technology improvement and productivity enhancement have been recognised as the key elements in economic development and the governments are generally eager to update the technology to realize the goal of economic development. According to economists, it can be shown that export promotion measures like export subsidies are definitely beneficial to developing countries in updating technology, improving productivity and stimulating employment'. See *India's replies to questions from the United States on its submissions (TN/RL/4 and TN/RL/26)* (TN/RL/W/99, 6 May 2003). The reference to stimulating employment might be based on the presence of surplus labor (labor market imperfections).

[2954] 'The subsidies, including export subsidies, serve merely to offset an existing handicap even though they may not meet the test of general availability'. India therefore (unsuccessfully, see below n 2960) proposed to place these subsidies outside the reach of actionable subsidy claims and CVDs action. *Submission by India, Elements of the framework for negotiations* (MTN.GNG/NG10/W/33, 30 November 1989), para 7; See also in the Doha Round: *India's Replies to Questions from the United States on its Submissions (TN/RL/4 and TN/RL/26)* (TN/RL/W/99, 6 May 2003).

differentiation in Annex VII between developing countries on the basis of their income level could be endorsed as the need for S&D treatment on export subsidies might be grossly related to their level of development.[2955] Yet, the exclusion of newly-acceded developing countries with income levels equally below the $1,000 GNP per capita levels clearly fails to honour this principle. The assumption that original WTO developing countries would have obtained their S&D treatment in return for higher levels of concessions does equally fail given that newly-acceded developing countries have generally made concessions that were far more extensive. Hence, no justification could be given for their exclusion.

Second, some small trading developing counties are allowed until 2015 to maintain specific programmes related to exemptions to exporters from the payment of import duties and internal taxes. These exemptions are often implemented in so-called export processing zones (EPZs). The set up of such EPZs is considered as an adequate development strategy so as to attract FDI and spur exportation in the first phase of development.[2956] The incentives offered to exporters in EPZs include, for example, exemptions on direct taxes and on tariffs paid on capital inputs and thus go beyond the rebates that would be allowed by virtue of Article 1 *juncto* the Illustrative List of the SCM Agreement. Yet, these small trading developing countries will have to bring their incentive programmes into conformity with the SCM Agreement as from 2015. This means that rebates offered to exporters will have to be confined to indirect taxes and tariffs on inputs consumed in the production process.[2957,2958] Notice that, according to Torres, improved infrastructure facilities which are often installed in EPZs (e.g., roads, ports, phone lines) are certainly not challengeable under the SCM Agreement. Such facilities would be covered under the 'general infrastructure'-exception (Article 1.1 (a)(1)(iii) of the SCM Agreement) and thus be excluded from the scope of the subsidy definition.[2959] Yet, it is not sure that infrastructure facilities limited to EPZs would be considered sufficiently generally available to be exempted from subsidy disciplines. Until present, the case law has not offered more guidance on the interpretation of this vaguely described exception.

[2955] It has been suggested that such differentiation between developing countries should also be inscribed under other WTO agreements because the general categorization of 'developing country' is not sufficiently fine-tuned. Obviously, developing countries with higher income-levels oppose such further differentiation.

[2956] See above Part I, Chapter 2, Section 2.4.4.

[2957] This means that those small trading partners will no longer be able to offer incentive schemes at more beneficial terms than other WTO Members so as to attract FDI.

[2958] Alternatively, the export contingency condition attached to incentives implemented in EPZs could be deleted. If this strategy is adopted, these schemes would no longer be prohibited under the SCM Agreement but would still be vulnerable to actionable subsidy claims and CVDs action. See Torres, above n 2640, at 220.

[2959] Torres, above n 2640, at 218.

This S&D treatment on export subsidies offered to a subset of low-income and small-trading developing countries is constrained in a double way. First, such export subsidies (e.g., excessive rebates in EPZs) remain actionable and countervailable (Articles 27.7 and 27.10 of the SCM Agreement).[2960] In my view, the importance of export subsidies as a development tool not only calls for raising the threshold to take unilateral CVDs action, but likewise suggests that the scope for actionable subsidies claims taken against export subsidies should be limited (Article 27.4 of the SCM Agreement).[2961] At present, it seems that WTO Members could base such claims on all types of adverse effects singled out under Article 5 of the SCM Agreement, whereas it would be appropriate to restrict such potential actions to the situations spelled out under Article 27.9 of the SCM Agreement. If this reasoning would be adopted, export subsidies would benefit from the same level of S&D treatment than the one offered to domestic subsidies.

Second, the right to offer export subsidies also extinguishes in case a developing country has reached export competitiveness in a certain product (Article 27.6 of the SCM Agreement). It seems unlikely that small-trading developing countries and LDCs will soon reach the required level of export competitiveness (3.25% in world trade) in any product. Rather, this extinction might be of more significance to larger export-oriented developing countries listed in Annex VII(b), such as India, Indonesia, the Philippines, Egypt, and Pakistan.[2962] Given that a positive determination of India's export competitiveness in textiles has recently been made, it will have to gradually phase out its export subsidies over a period of eight years. Although rather inscribed on request of other WTO Members to safeguard their trading interests, this export competitiveness exception also seems to serve as a useful exit mechanism in case export subsidies are no longer strictly needed.[2963] Indeed, export subsidies seem no longer optimal once the infant industry has grown up.[2964] For example, discovery-encouraging export subsidies to first-movers should only be temporary.[2965] Nonetheless, the 2009 World Bank study not only underlined the importance of the 'discovery phase' but equally emphasized the significance of the 'rapid-growth' or acceleration phase of exports.[2966]

[2960] Recall that export subsidies are deemed to be specific.
[2961] See discussion above under Part II, Chapter 6, Section 6.1.2.
[2962] See S. Creskoff and P. Walkenhorst, 'Implications of WTO Disciplines for Special Economic Zones in Developing Countries', *World Bank Policy Research Working Paper* (2009), 42 pp., at 23.
[2963] See above Part II, Chapter 1, Section 1.4; Part II, Chapter 6, Section 6.1.1.1.3. See, for example, *Submission by the United States* (MTN.GNG/NG10/W/29, 22 November 1989), at 2; *Communication from the United States* (MTN.GNG/NG10/W/20, 15 June 1988), at 7.
[2964] Other instruments (e.g., domestic subsidies) might become more useful. Rodrik even emphasized that incentives should only be provided to activities that are new to the domestic economy. See Rodrik, 'One Economics – Many Recipes', above n 2871, at 114.
[2965] See above Part I, Chapter 2, Section 2.4.2.1.
[2966] R. Newfarmer, W. Shaw, and P. Walkenhorst (eds), *Breaking Into New Markets – Emerging Lessons for Export Diversification* (Washington DC: The World Bank, 2009), 265 pp. See above Part I, Chapter 2, Section 2.4.2.

Because developing countries' exporters often fail to penetrate new markets (i.e., geographical diversification), graduation on the basis of export competitiveness should not occur too swiftly. This might underpin developing countries' proposals to redefine this concept in a way that export competitiveness is not achieved as a result of short-term market fluctuations and to introduce the stop-the-clock mechanism in case their share in trade drops again below the prescribed threshold. At the same time, the usefulness of this exit mechanism should urge WTO Members to solve their disagreements on the interpretation of essential elements revolving around export competitiveness (e.g., world trade, product level, starting point of graduation).

The major downside of this policy space on export subsidies (and domestic subsidies[2967]) is the risk that governments are captured by producers' interests when allocating subsidies. Therefore, some authors like Finger and Winters regret such flexibility as it prevents those countries to 'tie their own hands'.[2968] Yet, I would suggest that this inherent risk of any government intervention does not seem to justify further curtailing this policy flexibility under the WTO. To recall the conclusion of the 2009 World Bank study: 'laissez-faire policies combined with low tariffs are rarely sufficient to prompt dynamic export drives or overcome obstacles in other areas'.[2969] The prevalence of market failures combined with the importance of dynamic export drives simply calls for flexibility on subsidizing exports in low-income developing countries. Moreover, such an outward-oriented development strategy would generally be less prone to private capture than an import-substitution strategy because the former mostly entails a cost to the government whereas the latter generates tariff revenue. In addition, these low-income countries' budgetary constraints might *de facto* prevent governments from overly subsidizing their exporting sector or entering into subsidy war. Development assistance used to promote the trading sector might also offer some oversight when based on soft or hard conditionalities. Lastly, making such policy space subject to a development needs test under the WTO so as to prevent private capture does not seem a suitable option as well. Until 2003, other developing countries were precisely given the right to grant export subsidies insofar these were consistent with their development needs (Article 27.4 of the SCM Agreement). Confronted with this test, however, the Panel in *Brazil – Aircraft* correctly deemed this provision as 'troubling from the perspective of a panel' because:

[2967] See above Part IV, Chapter 3, Section 3.1.2.
[2968] Finger and Winters, above n 2922, at 387.
[2969] P. Brenton, R. Newfarmer, W. Shaw, and P. Walkenhorts, 'Breaking Into New Markets: Overview', in R. Newfarmer, W. Shaw, and P. Walkenhorst (eds), *Breaking Into New Markets – Emerging Lessons for Export Diversification* (Washington DC: The World Bank, 2009) 1-35, at 27-28; see above Part I, Chapter 2, Section 2.4.3.2.

> An examination as to whether export subsidies are inconsistent with a developing country Member's development needs is an inquiry of a peculiarly economic and political nature, and notably ill-suited to review by a panel whose function is fundamentally legal. Further, the SCM Agreement provides panels with no guidance with respect to the criteria to be applied in performing this examination. We consider that it is the developing country Member itself which is best positioned to identify its development needs and to assess whether its export subsidies are consistent with those needs.[2970]

For these reasons, the policy space offered to some developing countries to subsidize their exports should be preserved. At most, a more efficient notification procedure might increase the transparency on such export subsidies and reduce the risk of private capture.[2971] On the other hand, explicitly recognizing that such subsidies are granted might not be warranted as long as these are vulnerable for CVDs action by trading partners.

Before concluding, it should be reminded that the policy space offered to subsidize agricultural exports is conceptually different because it does not offer more extensive S&D treatment to the poorest developing countries. Indeed, those developing countries having listed export subsidies under Article 9 of the Agreement on Agriculture are allowed to offer such listed (or non-listed) export subsidies up to their final commitment level as undertaken during the Uruguay Round. On the basis of the latest proposal circulating in the Doha Round, these export subsidies would have to be phased-out by the end of 2016. In addition, Article 9.4 of the Agreement on Agriculture offers flexibility to offer transport and marketing export subsidies, which in its broad interpretation would be available to all developing countries. Here, the latest Doha Round proposal provides for the extinction of this flexibility by 2021 only. In light of the renewed importance attached to the potential of the agricultural sector in developing countries, such policy space might be considered appropriate.[2972]

3.2.2. The prohibition on export subsidies imposed upon other developing countries

The principle prohibition on export subsidies for non-agricultural products (Article 3.1 of the SCM Agreement) is fully enforceable against all other developing countries since 2003. As explained in Part I, authors belonging to the structuralist school have criticized the limitations set under the SCM Agreement upon developing countries' freedom to offer subsidies,

[2970] Therefore, the Panel considered that panels had to give substantial deference to the views of developing countries when confronted with this test. See Panel Report, *Brazil – Aircraft*, para 7.89 (footnotes deleted).
[2971] Article 25 of the SCM Agreement. The Trade Policy Review Mechanism (TPRM) already partly increases this transparency.
[2972] The need for diversification should not necessarily mean diversifying out of commodities into manufacturing goods though a single reliance on commodity trade might not be an optimal strategy given the volatility of this market.

whereby they primarily point to the ban on export subsidies.[2973] In these authors' view, those policy constraints would prevent developing countries to adopt the successful development path followed by the East-Asian Miracle countries and high-income countries in their early stages of development. Precisely formulating this argument, Lee has elaborated upon a specific proposal to lift the ban on export subsidies with regard to developing countries and to give these countries policy space to offer a certain amount of (export) subsidies set in accordance to their development level.[2974,2975] This level of so-called 'development-facilitation subsidies' would be exempted from any potential multilateral (i.e., actionable or prohibited subsidy claims) or unilateral (i.e., CVDs) response by other WTO Members and only be subject to a procedural safeguard so as to prevent abuse.[2976] Yet, Lee offers no details on the thorniest facet raised by his proposal: what amount of subsidies would be allowed for each developing country under such a sliding scale approach? He only puts forward that this 'needs to be further debated with respect to their effect on development'.[2977] Finally, Lee admits that his proposal might generate a detrimental subsidy race among developing countries, but this issue should be left to the judgment of the developing country in question: 'it will subsidize export industries that in its determination shows the best potential of success, and the possibility of these competing subsidies is part of the equation'.[2978]

Bringing together our discussion on the strategy followed by the East Asian Miracle countries and the analysis of the prohibition on export subsidies,[2979] one cannot but concur with the structuralist school's overall conclusion that such development strategy can no longer be copied by larger developing countries under the current WTO framework. In its revision of the factors explaining the East Asian success, the World Bank explicitly acknowledged the contribution of functional government interventions (i.e., targeting exports in general), though it was still somewhat more skeptical on the importance of selective interventions (i.e., subsidizing certain exporting sectors or industries in particular).[2980] Yet, even functional interventions directly targeting exports in general, like subsidized credits or R&D subsidies

[2973] See above Part I, Chapter 2, Section 2.4.1.
[2974] Y-S. Lee, 'Facilitating Development in the World Trading System – A Proposal for Development Facilitation Tariff and Development Facilitating Subsidy', 38:6 *Journal of World Trade* (2004), 935–954, at 948-954.
[2975] See also Y-S. Lee, 'Economic Development and the World Trade Organization: Proposal for the Agreement on Development Facilitation and the Council for Trade and Development in the WTO', in T. Chantal and J. Trachtman (eds), *Developing Countries in the WTO Legal System* (Oxford: Oxford University Press, 2009), 291-319.
[2976] Next to notification to the WTO, this would provide for prior public notice as well as public hearings on its implementation.
[2977] Lee, above n 2974, at 951.
[2978] Lee, above n 2974, at 952-953.
[2979] On the East Asian Miracle, see above Part I, Chapter 2, Section 2.4.1; for the analysis on export subsidies, see above Part II, Chapter 6, Section 6.1.1.
[2980] See above Part I, Chapter 2, Section 2.4.1.

available to all exporters, would likely be captured under the current prohibition on export subsidies as these are deemed to be specific under the SCM Agreement (Article 2.3 of the SCM Agreement).[2981] Making general available subsidies conditional upon export performance as part of a carrot-and-stick strategy is thus no longer allowed. Therefore, even if one doubts that selective interventions were important to explain the East Asian Miracle, it cannot be denied that a similar strategy targeting exports can no longer be put in place by a group of developing countries.

At the same time, the proposition that the success of this development strategy would urge a fundamental overhaul of the export subsidy disciplines with regard to developing countries might have to be nuanced as well.

First, more open trade regimes in exporting markets (e.g., lower tariff barriers and a decreased scope for competitive subsidization by other countries) might suggest that the same level of policy space from which the East Asian Miracle countries benefited may not be necessarily required to penetrate export markets. Indeed, it seems important to recognize that developed countries' policy space for subsidization as well as for imposing CVDs has likewise been constrained since the conclusion of the Uruguay Round. This is a major advantage of the current system for larger developing countries that is often neglected by those authors pleading for more policy space to developing countries. Take, for example, the rivalry between Brazil and Canada in the regional aircraft sector (Embraer versus Bombardier) that was fought out before the WTO (see above Part III). One might criticize the fact that the SCM Agreement precluded Brazil from offering export credit support at subsidized terms to Embraer even when, as the Panel equally acknowledged, this might have been consistent with its development needs.[2982,2983] At the same time, Brazil might never have won a subsidy war against Canada in the regional aircraft sector under the pre-SCM Agreement period. The

[2981] Recall that the condition of 'export contingency' is interpreted broadly under the case law.

[2982] In the words of the Panel:

> 'There could be any number of reasons why the provision of export subsidies might be consistent with a Member's development needs in such a case. For example, a developing country Member might be interested in the possible technological spin-off effects from the development and production of the product in question, or the need to establish a strong market presence and reputation in foreign markets as a stepping stone to introducing products with greater national value-added'.

Panel Report, *Brazil – Aircraft*, para 7.92.

[2983] Rodrik has exactly pointed to the outcome of this case against Brazil as an illustration that the WTO precludes development strategies employed by the East Asian Miracle countries:

> 'Brazil lost this case in the WTO, and will either remove the subsidies or have to put up with retaliation from Canada. Successful performers such as South Korea, Taiwan, and Mauritius subsidized their export industries for years without incurring similar actions.'

See Rodrik, 'One Economics – Many Recipes', above n 2871, at 226, footnote 13. Yet, it should be stressed that Brazil was successful in its various counterclaims against Canadian export subsidies.

strengthening of the disciplines upon Canada under the SCM Agreement might have reduced the need for Brazil to offer export subsidies so as to compete in this market.[2984]

Second, the tightening of export subsidy disciplines on developing countries that are higher on the development ladder might also be beneficial to lower income developing countries as it facilitates their penetration of new exporting markets. Again, the fact that a group of low-income developing countries still benefits from S&D treatment on export subsidies is regularly overlooked by proponents calling for more flexibility. For example, in making their claim for export subsidies to induce self-discovery, Hausmann and Rodrik criticize that '(n)ew international agreements in the context of the World Trade Organization have made such subsidies illegal'.[2985] Yet, all countries used as examples to underpin their claim for government interventions' inducing self-discovery are still allowed to use export subsidies to this end (e.g. India, Bangladesh, Pakistan, Honduras).[2986] Arguably, the value of their S&D treatment on export subsidies would be reduced if developing countries with higher income levels would also be allowed to employ such export subsidies.

Third, domestic rather than trade instruments such as export subsidies might become more relevant for developing countries that have reached a certain income level, even though the cut-off point is difficult to define. For instance, Rodriguez-Clare has argued that countries could in the first stage of development induce self-discovery along the lines suggested by Hausmann and Rodrik and that, once they have 'discovered' their comparative advantage, policies promoting clustering in some sectors should be put in place.[2987] Instead of 'hard' industrial policies such as import substitution or export promotion used in the initial phase, 'soft' industrial policies such as R&D subsidies, infrastructure investments, or regulatory reforms inducing clustering in some selected sectors should be employed in the next phase of development.[2988] Even if one considers inducing self-discovery still important in the further

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[2984] Developed countries were already subject to a prohibition on export subsidies under the Subsidies Code. Yet, the terms set under the OECD Arrangement were far less restrictive and the WTO dispute settlement system also improved the enforceability of this prohibition. See also above Part III, Chapter 1, Section 1.2.

[2985] R. Hausmann and D. Rodrik, 'Economic Development as Self-discovery', 72 *Journal of Development Economics* (2003), 603– 633. In other publications, Rodrik recognizes that some countries benefit from an exemption on export subsidies but he often limits this S&D treatment to LDCs (see, for example, below n 2992).

[2986] Only one of the listed examples has recently graduated (i.e., Dominican Republic).

[2987] Rodriguez-Clare gives the example of Costa Rica, which in the last decades effectively induced 'discovery' through 'hard' policies such as aggressive export promotion and FDI attraction. This has resulted in export diversification in agriculture (e.g., cut flowers and exotic plants) and manufacturing (e.g., textiles, medical devices, and microelectronic products). A. Rodríguez-Clare, *Microeconomic Interventions After the Washington Consensus* (Washington: Inter-American Development Bank, February 2005), 37 pp., at 23.

[2988] This would be more transparent and less costly. Rodriguez-Clare's suggestion to make a prior selection among all sectors which have shown to be successful in exporting (i.e., in which a country has revealed its comparative advantage) would likely be insufficient to categorize such grants as 'export subsidies' within the meaning of the SCM Agreement. Note in this respect that the SCM Agreement stage of development,[2989] increased government capabilities might make it no longer needed to rely upon export performance so as to assess successful discoveries (i.e., carrot-and-stick argument).[2990] In general, domestic market failures inhibiting further export diversification might not necessitate subsidies contingent upon exportation in case government capabilities and income levels have improved.[2991] Therefore, policy space for domestic rather than export subsidies might turn out particularly relevant in later stages of development. Once more, the reality that all developing countries are still enjoying more leeway to offer such domestic subsidies under the SCM Agreement seems not always sufficiently understood.[2992]

Fourth, exempting export subsidies offered by all developing countries might even have an adverse impact on the dynamic of further tariff negotiations.[2993] If, as under Lee's proposal, WTO Members would be precluded from CVDs or multilateral action against foreign subsidization, they might become reluctant to make tariff cuts that could be further eroded by such (export) subsidization. [2994,2995]

For all these reasons, proposals to reinstall substantive leeway to all developing countries on export subsidies might be neither strictly needed nor realistic as they would be opposed by developed as well as low-income developing countries. Yet, the activation of the prohibition

explicitly provides that '(t)mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy' (footnote 4 of the SCM Agreement). The Appellate Body has also underscored that export orientation of a firm may form '*a* relevant factor' but is insufficient on itself. See Appellate Body Report, *Canada – Aircraft*, para 173 (emphasis in the original); Rodríguez-Clare, above n 2987, at 28.

2989 See also above Part I, Chapter 4, Section 2.4.1.

2990 Rodrik, for example, proposes to organize bids for public resources on the basis of pre-investment proposals so as to subsidize costs of self-discovery. Rodrik, 'One Economics – Many Recipes', above n 2871, at 117.

2991 The interventions listed by Rodrik as part of a successful industrial policy do not necessitate export subsidies. Rodrik, 'One Economics – Many Recipes', above n 2871, at 117-119.

2992 For instance, Rodrik seems to stress the importance of leeway on domestic subsidization. Hereby, however, he does not take into account the S&D treatment on such subsidies offered under the SCM Agreement:

> '(T)he main external obstacle to the wider use of industrial policies by the larger developing countries is the WTO's Agreement on Subsidies. This Agreement prohibits the use of subsidies which take the form of fiscal expenditures conditioned on export performance. More seriously, it also renders "actionable" the use of subsidies that have the effect of increasing exports, even if they are not conditioned on exports. (Least developed countries are exempt from these rules). A literal application of this standard would rule of many kinds of industrial policies, the objective of which is precisely to increase the domestic supply of tradables'.

See D. Rodrik, 'Growth After the Crisis', above n 2871, at 23. Further, his observation seems not fully accurate because (i) S&D treatment on export subsidies applies to a broader group than just the LDCs group; (ii) LDCs do not benefit from more S&D treatment on domestic subsidies; and (iii) local content subsidies are not exempted but rather prohibited.

2993 See also below (Chapter 4, Section 4.2.2.) on the systemic justification for CVDs action.

2994 Such risk would be higher when green light is offered to *export* subsidies because of their more direct impact on trade compared to domestic subsidies.

2995 Even with the CVDs option in place, the technical and financial resources needed to implement such unilateral actions in conformity with the SCM Agreement arguably makes them an inefficient instrument for many developing countries to protect their import-competing industries' interest. Hence, these countries might still prefer substantive tariff overhang to be able to counter future subsidization.

on export subsidies with regard to developing countries is problematic insofar this ban is drafted in a way that reflects the interests of developed countries. Firstly, the discussion in Part III has amply demonstrated that the current disciplines on export credit support are detrimental to developing countries, even though the case law has partly reduced this disequilibrium (items (j) and (k) of the Illustrative List).[2996] Secondly, the fact that allowance for duty drawback systems is only foreseen for inputs 'consumed in the production of the exported products' (item (i) *juncto* Annex II of the SCM Agreement) also puts developing countries' exporters at a disadvantage because they face relatively higher tariff levels on capital imports.[2997] Although India's proposal in the Doha Round to allow for rebates on capital goods is considered solid on economic grounds, developed countries lack any incentive to concur because it would ease internal pressure to lower tariffs on capital inputs by developing countries.[2998] Likewise, India's demand to allow for a uniform drawback rate for exporters seems not to be endorsed by most WTO Members either, even though the thrust of this proposal equally seems valid as it lowers the administrative burden upon developing countries to implement such resource-intensive drawback systems.

According to Rodrik, disciplines imposed upon developing countries under the SCM Agreement might induce these countries to opt for undervalued currencies as a (inferior) strategy to boost exports.[2999] In the next section, this particular functional intervention acting as a subsidy on exports is examined in light of existing SCM Agreement disciplines.[3000] Could an undervalued currency be challenged or countervailed under the SCM Agreement?

3.2.3. Exchange rate policies under the SCM Agreement

Economic research suggests that an undervalued currency could be a sensible strategy to boost exports in the first phase of development.[3001] Because such a strategy comes at the

[2996] Remind that the case law has rejected an *a contrario* reasoning of the cost-to-government standard in items (j) and (k), paragraph 1 of the Illustrative List and has restrictively interpreted the scope for invoking the safe haven (OECD Arrangement).

[2997] Allowing drawbacks on capital inputs is precisely one of the measures that developing countries still benefit who from S&D treatment on export subsidies have implemented as part of their EPZs policy. However, these exemptions could still be challenged as actionable subsidies or be countervailed (see also below n 2998.

[2998] In expanding the scope for duty drawbacks under footnote 1 of the SCM Agreement *juncto* item (i) of the Illustrative List, such amendment would place drawbacks on capital inputs outside the reach of actionable subsidy claims or CVDs action as well.

[2999] D. Rodrik, 'Growth After the Crisis', above n 2871, at 15.

[3000] Policy tools to affect the real exchange rate are listed in D. Rodrik, 'The Real Exchange Rate and Economic Growth', *Working Paper* (October, 2008), 35 pp.

[3001] See above Part I, Chapter 2, Section 2.4.2. Mattoo and Subramanian hold that an undervalued currency is 'the most mercantilist policy imaginable' because it is both an import tax and export subsidy. At the same time, they acknowledge that an undervalued currency 'can be a tool for economic development—at least, ruling it out as a tool would be difficult to justify on economic grounds'. They expense of trading partners (i.e., in the form a trade deficit), an undervalued currency becomes, however, problematic in case it is sustained by a country that has a substantive share in world trade. This is precisely the reason why China's undervalued currency has attracted increased criticism over the last years. The growing trade imbalance with China has prompted the question in the US whether an undervalued exchange rate could be challenged or countervailed under the SCM Agreement.[3002,3003] For those developing countries still benefiting from S&D treatment on export subsidies, this question is relevant insofar the qualification as a specific subsidy would make their products benefiting from an undervalued exchange rate vulnerable to CVDs action.[3004] Those countries like China that do not benefit from S&D treatment on export subsidies might in addition be confronted with a prohibited subsidy claim before the WTO.

In essence, China operates an exchange rate policy whereby the yuan/dollar exchange rate is kept stable.[3005,3006] Through interventions in the foreign exchange market (i.e., selling yuans in exchange for dollars), the People's Bank of China prevents that its growing trade surplus would lead to a (faster) appreciation of the yuan vis-à-vis the dollar.[3007] In economic terms, such an undervalued exchange rate works as a combination of an import duty and an export subsidy.[3008] Overall, most scholars are rather sceptical that an effect similar to an across-the-board export subsidy is sufficient to label it as an export subsidy in legal terms, although all acknowledge that this query is certainly not settled as of yet.[3009,3010,3011] Overall, I concur that

suggest applying a similar income threshold on exchange rate policies as the one inscribed under the SCM Agreement on export subsidy disciplines. To be sure, they consider that an undervalued currency is actually not captured under the export subsidy definition of the SCM Agreement. A. Mattoo and A. Subramanian, 'Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade, Organization', *Peterson Institute for International Economics – Working Paper Series* (January 2008), 31 pp., at 5 and 12.

[3002] At the moment of writing, the US Commerce Department is again considering whether this would qualify as a countervailable subsidy.

[3003] The argument that China's exchange rate regime could be challenged under Article XV:4 of the GATT is not discussed. Notice only that this claim requires demonstration that this regime 'frustrates the intent of the provisions of this Agreement'.

[3004] An actionable subsidy claim would be unlikely but is not ruled out legally.

[3005] Exchange rate policies refer to the 'determination of the value of the local currency expressed in a foreign currency'. See E. Denters, 'Manipulation of Exchange Rates in International Law: The Chinese Yuan', *ASIL Insights* (November 2003).

[3006] For technical details on China's current exchange rate regime, see R. W. Staiger and A. O. Sykes, 'Currency "manipulation" and world trade: a caution', in S. J. Evenett (ed), *The US-Sino Currency Dispute: New Insights from Economics, Politics and Law* (London: CEPR, 2010), 109-113.

[3007] In fact, China allowed some appreciation of the yuan against the dollar in recent years but this appreciation would be larger without interventions. Most commentators agree that the yuan is still undervalued.

[3008] See, for example, Staiger and Sykes, above n 3006; Mattoo and Subramanian, above n 3001, at 5.

[3009] Authors being sceptical on whether an export subsidy determination could be made: D. Ahn, 'Is the Chinese Exchange-rate Regime WTO-legal?', in S. J. Evenett (ed), *The US-Sino Currency Dispute: New Insights from Economics, Politics and Law* (London: CEPR, 2010), 139-145; C. Herrmann, 'Don Yuan: China's "Selfish" Exchange Rate Policy and International Economic Law', in C. Herrmann and an undervalued exchange rate, like the Chinese currency, would very likely not pass the different criteria (i.e., financial contribution, benefit, specific) to qualify as a challengeable or countervailable subsidy under the SCM Agreement.[3012]

3.2.3.1. Financial contribution analysis

Bringing an undervalued exchange rate under the financial contribution (or income or price support) element seems to contradict the closed list approach.[3013] However, a variety of counterarguments have been articulated under all three types of financial contributions listed in Article 1.1(a) of the SCM Agreement.

First, Magnus and Brightill consider that a financial contribution exists 'any time a government and a company trade one thing for another, even yuans for dollars'.[3014] After all, governments participating in exchange transactions are directly providing 'goods' (Article 1.1(a)(1)(iii)) or transferring 'funds' (Article 1.1(a)(1)(i)) and, in case they rely on private banks to handle exchanges, they would 'entrust' private bodies to make such contributions

J.P. Terhechte (eds), *European Yearbook of International Economic Law 2010* (Berlin: Springer-Verlag, 2010), 31-51; G. Hufbauer and C. Brunel, *The US Congress and the Chinese Yuan* (Washington DC: Peterson Institute for International Economics, October 2007), 20 pp.; G. C. Hufbauer, Y. Wong, and K. Sheth, *US – China Trade Dispute: Rising Tide, Rising Stakes* (Washington: Peterson Institute for International Economics, August 2006), 122 pp.; Staiger and Sykes, above n 3006; Mattoo and Subramanian, above n above n 3001; J. P. Trachtman, 'Yuan to fight about it? The WTO legality of China's exchange regime', in S. J. Evenett (ed), *The US-Sino Currency Dispute: New Insights from Economics, Politics and Law* (London: CEPR, 2010), 127-131; M. Waibel, 'Retaliating against exchange rate manipulation under WTO rules', in S. J. Evenett (ed), *The US-Sino Currency Dispute: New Insights from Economics, Politics and Law* (London: CEPR, 2010), 133-137.

3010 Authors being less sceptical on whether an export subsidy determination could be made: M. Benitah, 'China's Fixed Exchange Rate for the Yuan: Could the United States Challenge it in the WTO as a Subsidy?', 117 *ASIL Insight* (October 2003) (this author concludes that it would not be easy but still possible to make such determination); J. Magnus and T. C. Brightbill, 'China's Currency Regime is Legitimately Challengeable as a Subsidy under ASCM rules', in S. J. Evenett (ed), *The US-Sino Currency Dispute: New Insights from Economics, Politics and Law* (London: CEPR, 2010), 147-152; J. Magnus, 'Chinese Subsidies and U.S. Responses', *Testimony before the U.S. - China Economic and Security Review Commission – Hearing on China's World Trade Organization Compliance: Industrial Subsidies and the Impact on U.S. and World Markets* (5 April 2004), 7 pp.

3011 The so-called 'China Currency Coalition' (recently renamed to 'Fair Currency Coalition') is a group of US industry, service, and labor organizations that pleads for the imposition of CVDs against Chinese imports on the basis of its undervalued currency.

3012 Recall that China does not benefit from any exception with regard to the prohibition on export subsidies.

3013 To phrase the words of the Appellate Body, the financial contribution element 'involves consideration of the nature of the transaction' (Appellate Body Report, *US – Softwood Lumber IV*, para 52) and exchange rate transactions do not seem to be included. For authors expressing doubts on whether the financial contribution element would be passed: Ahn, above n 3009, at 142; Herrmann, above n 3009, at 49; Hufbauer and Brunel, above n 3009, at 10; Hufbauer, Wong, and Sheth, above n 3009, at 21-22; Trachtman, above n 3009, at 130; Waibel, above n 3009, at 135.

3014 In a previous contribution, Magnus had clarified that 'all governments that participate in exchange transactions are providing financial contributions – either directly under Article 1.1(a)(1)(iii) or, if they rely on private banks to handle exchanges, via the "entrusts or directs" standard of Article 1.1(a)(1)(iv)'. Alternatively, he suggested that such exchange transaction would qualify as a 'direct transfer of funds' (Article 1.1(a)(i)). Magnus, above n 3010, at 4.

(Article 1.1(a)(1)(iv)).[3015] Nonetheless, Hufbauer et al have accurately responded that such a strong conclusion would need 'verbatim SCM language to prevail' because it would imply that any central bank operation in the foreign exchange market would qualify as a financial contribution under the SCM Agreement.[3016]

Second, it has been suggested that the Chinese government would provide a service (Article 1.1(a)(1)(iii)) in the form of currency hedging as a result of keeping the exchange rate stable.[3017] The argument goes that such a stable exchange rate regime would free Chinese exporters from hedging against foreign exchange risk. Yet, bringing in this way fixed exchange rate regimes within the scope of the SCM Agreement would likely not be successful. If such a service would be considered contingent upon exporting, this reasoning would generate the untenable conclusion that all fixed exchange rate regimes would simply be prohibited under the SCM Agreement.[3018] If the service would not be considered contingent upon exportation because Chinese importers benefit as well, it would be non-specific under Article 2 of the SCM Agreement.

Third, some have argued that China 'foregoes revenue' (Article 1.1(a)(1)(ii)) because the undervalued exchange rate would make imports more expensive. Hence, the government would forego tariff revenue. Yet, this argumentation might be difficult to endorse as well. Indeed, Staiger and Sykes have questioned the economic validity of this argument because it is not sure that net tariff revenues would effectively fall back under such exchange rate regime.[3019] Moreover, there is no precedence that any budget cost resulting from an undervalued exchange rate could qualify as revenue foregone.[3020] Here, the financial contribution (i.e., revenue foregone upon imports) would seem to be too unrelated to the challenged benefit upon exporters (i.e., subsidy upon exports).

3.2.3.2. Benefit analysis

On the whole, the most credible suggestion regarding the financial contribution element would be to label foreign exchange transactions as a direct transfer of funds (Article

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[3015] Staiger and Sykes also suggest that exchange transactions by the government are 'direct transfer of funds' to entities trading in the foreign exchange market. Although these transactions are mostly not made by domestic exporters, these authors underscore that such a direct transfer to exporters is not required under Article 1.1(a) of the SCM Agreement. R. W. Staiger and A. O. Sykes, ' "Currency manipulation" and World Trade', *NBER Working Paper* No. 14600 (December 2008), 42 pp., at 32-33.

[3016] Hufbauer, Wong, and Sheth, above n 3009, at 21, footnote 28.

[3017] This was argued by the 'China Currency Coalition' and referred to by Magnus (above n 3010).

[3018] Such a service would be considered extended at beneficial terms because no cost is charged. According to Magnus, '(a)s far as I can tell, exporters pay nothing for this service. "Nothing" might well be characterized as "less than adequate remuneration." Indeed, if the currency regime really does include this feature, it might even be considered a *per se* ASCM violation under item (j) of the *Illustrative List of Export Subsidies* (ASCM Annex 1) (…)'. Magnus, above n 3010, at 5.

[3019] Staiger and Sykes, above n 3015, at 32-33.

[3020] Hufbauer and Brunel, above n 3009, at 10; Hufbauer, Wong, and Sheth, above n 3009, at 21-22.

1.1(a)(1)(i)). But even if this too creative interpretation would be accepted, it should still be determined that such foreign exchange transactions confer a benefit (Article 1.1(b) of the SCM Agreement). Again, this threshold is not easily passed. Two different types of benchmarks seem to be suggested.

On the one hand, the nature of the financial contribution might refer to the foreign exchange market to discern the appropriate benchmark. Hereby, the benefit analysis would not focalize on exporters but on all entities trading in the foreign exchange market: is this transfer of funds to entities trading in the foreign exchange market extended at better-than-market terms? Yet, as Magnus acknowledges,[3021] there exists no separate private market in or outside China for dollar-to-yuan exchanges at privately negotiated prices (i.e., where a lower price would be paid for yuans than the rate set by the Chinese government).[3022] Hence, actors operating in the foreign exchange market do therefore not seem to receive a benefit in the technical meaning of the SCM Agreement.

On the other hand, most authors refer to the outcome of the government's foreign exchange interventions to address the benefit analysis: the generated undervalued exchange rate would benefit exporters in particular. Although the financial contribution (i.e., foreign exchange transaction) would in most cases not directly involve exporters, a benefit in the form of an undervalued exchange rate would be present. As correctly emphasized by scholars, the pass-through cases (e.g., *US – Softwood Lumber IV*) have shown that the recipient of the financial contribution and the beneficiary should not be one and the same person to qualify as a subsidy under the SCM Agreement.[3023] So, one might suggest that the pass-through cases indicate that a direct transfer of funds to exporters is not strictly required. However, a key difference with those pass-through cases is that the initial recipient does not seem to receive a benefit in the legal sense.[3024] As argued in the previous paragraph, entities trading in the foreign exchange market do not seem to receive a benefit in the legal sense. Even in case the benefit analysis would focalize on the appropriateness of the exchange rate, such an assessment by a panel or CVDs-investigating authority would not only be highly sensitive in political terms but also notoriously difficult in economic terms.[3025] Indeed, what level of exchange rate would be singled out as benchmark to reach the conclusion that the actual exchange rate is undervalued?[3026]

[3021] Magnus, above n 3010, at 5.

[3022] Magnus makes this argument with regard to the provision of a 'good' (Article 1.1(a)(1)(iii) of the SCM Agreement).

[3023] Staiger and Sykes, above n 3015, at 32. See above Part II, Chapter 3, Section 3.2.2.

[3024] The benefit upon the exporters is also inherent in the transaction in case of export credit support.

[3025] Moreover, Staiger and Sykes have explained that price adjustments might offset benefits of an undervalued exchange rate. Staiger and Sykes, above n 3015.

[3026] Strictly speaking, a panel is not obliged to exactly quantify the benefit upon exporters under Article 1.1(b) of the SCM Agreement. In contrast, a CVDs-investigating authority will have to make such calculation to make sure that CVDs are not imposed beyond the conferred benefit.

3.2.3.3. Specificity analysis

Finally, if an undervalued exchange rate would meet the criteria of a subsidy under the SCM Agreement, it still has to fulfil the specificity element to be disciplined and countervailable (Article 2 of the SCM Agreement). Because the exchange rate is generally applicable, this hurdle can only be met if it is shown that the undervalued exchange rate is contingent upon exportation.[3027] Indeed, an export subsidy is deemed to be specific by virtue of Article 2.3 of the SCM Agreement. Once more, conflicting views have been expressed on whether the export contingency element is fulfilled. Some scholars hold that the exchange rate is not contingent upon exports since it applies across the board to all sorts of transactions (e.g., transfers for direct investments in China).[3028] Others, however, conclude that an undervalued exchange rate is *de facto* tied to exports because it predominantly benefits exporters.[3029] Clearly, the latter view relies upon an expansive interpretation of the concept of *de facto* export contingency.[3030] If this third element would be met, an undervalued exchange rate would be countervailable as well as prohibited under the SCM Agreement (Article 1 *juncto* 3 of the SCM Agreement).[3031]

3.2.3.4. Conclusion

This discussion has amply demonstrated that it would be highly difficult to categorize an undervalued exchange rate regime as an 'export subsidy' under the SCM Agreement. It would require a creative and expansive interpretation of all different elements stipulated in Article 1 *juncto* 3 of the SCM Agreement. This lack of clarity suggests that WTO Members would have been much more specific if they had intended to prohibit an undervalued exchange rate regime as an export subsidy under the WTO.[3032] As Ahn accurately explained, the fact that the detailed Illustrative List does not include this 'well known – probably the most important – contributing factor for export promotion' indicates that they did not meant to outlaw an undervalued exchange regime under the SCM Agreement. Along the same lines,

[3027] In the words of Hufbauer and Brunel, '(c)hanges in exchange rates and interest rates would seem to be the opposite of "specific" policies. They rank among the broadest measures that a government can employ to influence the economy'. Hufbauer and Brunel, above n 3009, at 11.
[3028] See for example Ahn, above n 3009, at 142, Herrmann, above n 3009, at 49; Trachtman, above n 3009, at 130; Waibel, above n 3009, at 136.
[3029] See Benitah, above n 3010; Magnus, above n 3010, at 6.
[3030] Observe in this respect that the financial contribution (i.e., foreign exchange transactions by the government) is certainly not contingent upon exportation. However, according to the latter group of authors, the alleged benefit upon exporters (i.e., undervalued exchange rate) would be contingent upon exports.
[3031] With regard to developing countries benefiting from S&D treatment on export subsidies, such an undervalued exchange rate would be challengeable as an actionable subsidy (Article 27.7 of the SCM Agreement).
[3032] The lack of clarity would also direct a panel towards the negotiating history as supplementary means of interpretation (Article 32 of the Vienna Convention).

Hufbauer and Brunel consider that 'they would have said so – in the (SCM Agreement) or predecessor agreements, stretching back to the 1960s'.[3033] In fact, there was no need to include devalued exchange rates as a form of export subsidy at the time the initial list was drafted (i.e., 1960 Declaration) because of the par value system operated by the IMF. Already during the initial GATT/ITO negotiations on export subsidies, it was recognized that the risk of competitive devaluations was reduced under this system because such devaluations needed IMF approval. Hence, oversight of the exchange rate was considered a matter dealt with by the IMF. Since the collapse of the par value system in the 1970s, the risk of such competitive devaluations is no longer prevented by the IMF as leaves its Members in principle free to choose their exchange rate system.[3034] Yet, if GATT Contracting Parties had meant to close this important loophole by qualifying an undervalued exchange rate as a prohibited export subsidy, they would – and should – have been much more explicit as this would generate a fundamental overhaul in the division of tasks between the IMF and the GATT/WTO.[3035] Interestingly and somewhat ironic in light of the current debate, the US tabled the precisely opposite proposal in the GATT when it abandoned the par value system and devalued the dollar in the beginning of the 1970s. It fruitlessly suggested adding to the list of prohibited export subsidies:

> Special government measures to offset, in whole or in part, the price disadvantages on exports that result from its own or other countries' exchange rate adjustments.[3036]

To be clear, such compensation to exporters for its own or other countries' exchange rate adjustments would actually qualify as a prohibited export subsidy under Article 1 *juncto* 3 of the SCM Agreement and thus be prohibited, unless a WTO Member benefits from S&D treatment on export subsidies. In contrast, the argument that an undervalued exchange rate qualifies as a prohibited export subsidy could not be endorsed in the absence of a clear textual basis and support in the negotiating history.

[3033] Hufbauer and Brunel, above n 3009, at 10; Hufbauer, Wong, and Sheth, above n 3009, at 21-23.
[3034] There is only an explicit obligation to avoid manipulating exchange rates, but the IMF lacks an effective mechanism to enforce this obligation. On the obligations of IMF Members under the IMF Articles of Agreement, see Herrmann, above n 3009, at 40-45.
[3035] They could have either added it to the Illustrative List or discussed its inclusion under Article 1 *juncto* 3 of the SCM Agreement.
[3036] *Proposal by the United States, Supplementary List of Practices that Constitute an Export Subsidy* (INT(73)58, 26 June 1973).

4. DISCIPLINES ON COUNTERVAILING MEASURES

Upon fulfilment of procedural and substantive requirements spelled out under the SCM Agreement, WTO Members are allowed to levy unilateral CVDs measures on imported products for the purpose of offsetting specific subsidies. Recapitulating to some extent the theory set out in Part I, this section starts with an elaboration of the rationale for imposing such CVDs. Why do individual countries choose to impose CVDs? Conversely, why would other countries show an interest in limiting the reach of such CVDs in a multilateral trading system? Both inquiries will lead us to the normative assessment of the scope for CVDs action that should be given under WTO. This normative analysis will be developed through an introduction on the historical debate in the US on the purpose of its CVDs action.

4.1. THE RATIONALE FOR IMPOSING AND RESTRICTING CVDS ACTION

In Part I, it was explained that countries do not seem to be inspired by the objective to maximize national welfare when imposing CVDs.[3037] After all, countries would rather send a 'thank you note' to the subsidizing country instead of imposing CVDs in light of the welfare-improving effects of subsidized imports (i.e., term of trade benefit). In fact, only in very specific circumstances could CVDs be used as welfare-improving instruments. Three such situations have been distinguished. First, a large country could craft an 'optimal CVD' under which the created distortions would be more than compensated by a terms of trade gain. Yet, information requirements to set up this 'optimal CVD' might be highly demanding and welfare would also fall back again to the pre-subsidy level in case such CVDs would effectively lead to the withdrawal of the foreign subsidy.[3038] Second, in strategic trade settings, CVDs could be useful to claw back some rents deprived by foreign profit-shifting export subsidies. But again, information requirements (e.g., on the strategic trade relationship) make it questionable whether CVDs could hereby be designed in a welfare-maximizing way.[3039] Third, in times of congestion in the labor market, CVDs could be useful to slow the adjustment process in the import-competing industry. However, safeguards would be a more appropriate instrument to this end.

In sum, the difficulty in each of these three situations to effectively employ CVDs as national welfare-maximizing instrument puts further doubt on whether governments are effectively concerned with the goal of enhancing welfare when considering CVDs action. Rather, CVDs action in most cases only serves producers' welfare in the import-competing market at the

[3037] See above Part I, Chapter 1, Section 1.3.
[3038] Moreover, the static welfare analysis also neglects that trade protective instruments such as CVDs might hamper productivity improvements in the importing country. See above n 55.
[3039] At the same time, Sykes observes that CVDs 'may be less harmful on average in case they roughly fit the strategic trade paradigm'. Sykes, above n 2665, at 707.

expense of national welfare. This suggests that the rationale for imposing CVDs should be explained in political-economy terms (i.e., protecting the interests of producers) rather than in national welfare-maximizing terms.[3040,3041]

Significantly, Grossman and Mavroidis have found support for this conclusion in the disciplines on CVDs measures elaborated upon in the SCM Agreement.[3042] Indeed, as explained in Part II, CVDs action is not confined to those situations in which a presumption of a welfare loss has been demonstrated but only depends upon the demonstration of injury to the domestic industry. Similarly, the 2009 World Trade Report concurred that disciplines in the SCM Agreement 'support the idea that governments need countervailing duties to help domestic producers' and that '(p)olitical economy considerations help to explain why governments might use countervailing duties'.[3043,3044] Analogous political-economy considerations might arguably explain why alleged subsidizing countries have advocated multilateral disciplines restricting the leeway for CVDs measures. To preserve the interests of their exporters to the US market, countries have systematically urged in different GATT/WTO rounds to put more stringent disciplines on this unilateral response in place. Here, their proposals, likely motivated by political-economy reasons, might be justified on welfare grounds as well. Even in those limited situations where they could be considered welfare-improving for the country undertaking such unilateral action, CVDs come at the expense of welfare in the rest of the world and in the subsidizing country in particular. Only if they would help governments to deter 'wasteful' subsidization (i.e., 'tie their hands'), WTO Members might be grateful that such system for CVDs action is in place in trading partners. This brings us to the inquiry on whether a normative argument could be constructed justifying a multilateral trading system that gives leeway to impose CVDs. Could such a system be defended even though governments' motive to take such action is to protect the narrow interests of their producers and given the welfare effects are generally detrimental to both the CVDs imposing country and the world as whole?

[3040] Jackson also concluded that the motive of governments in applying CVDs is 'to maximize the producers who constitute important political constituencies within the country'. J. H. Jackson, 'Perspectives on CVDs', 21 *Law & Policy in International Business* (1990), 739-761, at 743.

[3041] Sykes notes that, in practice, CVDs also seem to be imposed in industries in which the forces of protection are active. Sykes, above n 2661, at 103.

[3042] Grossman and Mavroidis, 'Here Today, Gone Tomorrow?', above n 2666, at 198-199.

[3043] The injury test also supported 'the idea that the main rationale for countervailing duty law is to protect an entitlement of domestic producers to be insulated from the harmful effects of foreign subsidies rather than to promote global efficiency'. WTO Secretariat, *World Trade Report 2009 – Trade Policy Commitments and Contingency Measures* (Geneva: WTO Publications, 2009), 171 pp., at xviii.

[3044] World Trade Report 2009, above n 3043, at xvii.

4.2. THE RATIONALE FOR ALLOWING CVDS ACTION UNDER A MULTILATERAL TRADING SYSTEM

In the 1980s, a vivid discussion emerged on the purpose of the CVDs law in the US, by far the main user of CVDs and being under pressure in GATT negotiations to restrict the scope of its CVDs law. Displaying a somewhat blurred distinction between positive and normative theory,[3045] this debate was initiated by Goetz, Granet, and Schwartz and further elaborated upon by Diamond.[3046] These authors criticized the deterrence or global efficiency rationale[3047] of CVDs law, according to which CVDs help to promote the efficiency of global resource allocation by deterring 'inefficient' (i.e., global welfare-reducing) subsidization. In their view, this deterrence rationale is unconvincing because it ignores that subsidies might be appropriate to correct market failures and thus lead to a more efficient resource allocation (e.g., stimulating activities that generate positive externalities).[3048] In short, by failing to distinguish 'good' from 'bad' subsidies, CVDs laws cannot be explained on the basis of deterring wasteful subsidization. For that reason, these authors have postulated an alternative rationale for CVDs law, labeled the 'entitlement rationale':

> The entitlement rationale is equally consistent with a 'property rights' stance that views domestic firms having a right to 'insulation' from adverse and uncompensated international manipulations, even if such manipulations are efficiency-enhancing in a more global sense.[3049]

Hence, according to the proponents of this entitlement theory, the purpose of CVDs is (should?) not (be) to deter subsidization but to offset its effect in the US. In the words of Diamond, 'the proper purpose (of CVDs law) is not to deter all foreign subsidies, but, rather, to assure domestic producers that foreign subsidies will not allow recipient firms to increase their direct competitive position in the US market'.[3050] Therefore, the level of CVDs should not be based on the full amount of the benefit generated by the subsidy to the recipient, as the deterrent approach would suggest, but on the level of injury caused to the import-competing industry in the US market.[3051] Only if – and to the extent that – subsidies affect marginal costs, firms will decide to increase output. It is only in that case that import-competing

[3045] Indeed, it is unclear whether they aimed at revealing the actual purpose of CVDs law (i.e., what its purpose is?) or its normative purpose (i.e., what its purpose should be?).
[3046] Goetz, Granet, and Schwartz, above n 2671, at 17-32; Diamond, above n 2671, at 767-812; Diamond, above n 2670, at 507-608.
[3047] This is also called the 'efficient resource allocation' rationale.
[3048] Goetz, Granet, and Schwartz, above n 2671, at 17-18; Diamond, above n 2671, at 778-780. Diamond also referred to the Tokyo Round Subsidies Code which acknowledged the potential proper role of domestic subsidies.
[3049] Goetz, Granet, and Schwartz, above n 2671, at 19
[3050] Diamond, above n 2671, at 811.
[3051] This difference in positions also fits the broader and older debate between the 'injury-only' school and the 'anti-distortion' view. The first school is principally concerned with correcting the injury that comes from subsidized trade, whereas the latter school highlights the inefficient consequences of subsidization. See Hufbauer and Erb, above n 2883, at 19-24.

producers will be negatively affected (i.e., lower output at a lower price) and that CVDs should be imposed.[3052]

Yet, Sykes, Trebilcock, as well as Jackson rightly discovered an ambiguity in the entitlement theory: it fails to explain why such an entitlement to national producers could be normatively endorsed.[3053] Why should producers be entitled to CVDs action offsetting injury imposed upon them, given that foreign subsidization could very well be global and national welfare-improving? Put differently, why should the (correct) dismissal of the deterrence rationale imply the adoption of the entitlement theory if the first-best option with regard to CVDs law seems rather simple from a welfare perspective: 'abandon it'.[3054] Insofar adherence to the entitlement theory would result in lower levels of CVDs, it could in Sykes' view be welcomed as a kind of second-best reform in case abandoning CVDs is politically unfeasible. Yet, he even doubted whether lower CVDs levels would be achieved if the entitlement rationale would be endorsed.[3055]

This discussion perfectly introduces our examination on whether the SCM Agreement should allow for the imposition of CVDs (i.e., normative theory perspective). Broadly speaking, three different lines of argumentation could be distinguished.[3056] These are discussed in more detail.

4.2.1. The deterrence justification

Proponents of the deterrence or global efficiency justification would argue that CVDs promote the efficiency of global resource allocation by deterring wasteful subsidization.[3057] Thus, the threat or actual use of CVDs by trading partners would help national governments to withstand pressure from their producers who lobby for welfare-detrimental subsidies. Yet, this justification is based on two assumptions that do not seem to hold: CVDs should only (or primarily) target *wasteful* subsidization and should be able to effectively *deter* such subsidization.

[3052] A firm's marginal revenue is a function of market demand, whereas it marginal costs is a function of production costs. In contrast to variable costs, fixed costs do not vary with the level of production in the short-run.
[3053] Sykes, above n 2665, at 701; M. J. Trebilcock, 'Is the Game Worth the Candle? Comments on a Search for Economic and Financial Principles in the Administration of U.S. Countervailing Duty Law', 21 *Law & Policy in International Business* (1990), 723-737, at 728; Jackson, above n 3040, at 742.
[3054] Sykes, above n 2665, at 700, 701.
[3055] Sykes and Trebilcock also questioned whether it would be feasible to implement the entitlement theory in practice because determination of the subsidy effect on marginal costs seems notoriously difficult. Sykes, above n 2665, at 717; Trebilcock, above n 3053, at 726-727.
[3056] These positions are distinguished by Sykes, above n 2928.
[3057] Magnus refers to the importance of the subsidy-deterring potential of CVDs. J. R. Magnus, 'World Trade Subsidy Discipline: Is This the "Retrenchment Round"?', 38:6 *Journal of World Trade* (2004), 985-1047, at 991.

First, as stressed by proponents of the entitlement theory, CVDs might in practice very well target legitimate foreign subsidies that aim at correcting market failures. Also under the SCM Agreement, there is no guarantee whatsoever that CVDs merely target 'wasteful' subsidies. After all, subsidies offered by developing countries are not shielded from CVDs action, even though it is explicitly recognized in the SCM Agreement that subsidization may play an important role in these countries' development strategies. Moreover, CVDs action against developed countries is surely not confined to wasteful subsidization as subsidies that were previously offered green light status (e.g., R&D subsidies) have become countervailable.

Second, even in case CVDs would target wasteful subsidization, the deterrence justification only holds when CVDs would effectively deter the allocation of such subsidies. This first of all means that the deterrence justification could at most underpin CVDs action by large countries.[3058] Indeed, CVDs imposed by small countries do not affect foreign producers and will therefore not alter foreign governments' behaviour. Assessing whether CVDs systems set up in large countries in reality deter foreign subsidization is rather complicated because the threat of such CVDs action might precisely prevent the allocation of subsidies in the first place. Hence, the most effective way of deterrence (i.e., preventing the use subsidies) is not directly observable in the data.

Back in the 1980s and on the basis of discussions with government officials, Jackson provided some anecdotic evidence documenting that potential US CVDs action induced other countries to rethink their subsidy programmes.[3059] He therefore suggested that US CVDs laws had some effect on discouraging the use of subsidies. Yet, Sykes was at that time more skeptical that the US CVDs action was indeed effective in this respect, because the unilateral imposition by a single country will deter subsidization by other countries only by hazard.[3060] Turning to the present situation, Sykes observes that only a limited number of WTO Members use CVDs and that they have merely taken such action in a relatively small number of cases. Such sporadic and uncoordinated CVDs action could simply divert subsidized products to other countries, which strongly reduces their deterrent effect. Moreover, CVDs action will only be undertaken against subsidy programmes if and when those become known to trading partners. When detection takes time, recipients will benefit from subsidization before the CVDs measure is put in place.[3061] The 2009 World Trade Report concurred with Sykes'

[3058] See also Jackson, above n 3040, at 744.

[3059] Making an accurate distinction between positive and normative theory, Jackson concluded that 'if the world would be better off if there were a general reduction of the use by governments of subsidies relating to products that flow in international trade, one could argue that the U.S. policies, motivated for entirely different reasons, may fortuitously or coincidentally be having a salutary effect on the world economy'. Jackson, above n 3040, at 745, 755.

[3060] See also Sykes, above n 2928, at 260.

[3061] See Sykes, above n 2661, at 104.

argumentation and thus agreed that it is doubtful that the threat of CVDs action within the WTO system does much to discourage subsidization.[3062]

Proponents of the deterrence justification would principally favour rather flexible procedural and substantive disciplines on the imposition of CVDs so as to maximize their deterrent effect. For instance, making the lesser-duty-rule mandatory under the SCM Agreement would be unwise from this perspective.[3063] To effectively deter foreign subsidization, CVDs should remain allowed up to the subsidy level calculated in terms of the benefit to the recipient, even if injury upon the domestic industry would be inferior.[3064] Remind in this respect that Qiu has demonstrated that CVDs up to the ceiling set under the SCM Agreement (i.e., subsidy level) might even be insufficient in strategic settings to fully deter export subsidization for profit-shifting reasons.[3065] Next, the deterrent effect would likely be stronger if more large countries would effectively implement CVDs procedures and undertake such unilateral action. This would suggest that the procedural burden to undertake such action should not be set too demanding, certainly not for larger developing countries.

Yet, pursuing the objective to maximize the deterrent effect in rethinking the SCM Agreement disciplines seems not appropriate. Even when leaving aside the question whether such deterrent effect could really be sufficiently boosted,[3066] pursuing this goal would not alter the fundamental flaw in the deterrence rationale: CVDs simply do not detect and deter wasteful subsidization only. What is more, even if only wasteful subsidies would be singled out under the SCM Agreement, an efficient multilateral track would be superior because its deterrent effect would not come at the welfare cost caused by unilateral measures.[3067]

4.2.2. The systemic justification

As elaborated above,[3068] Kenen has suggested that the prohibition on export subsidies could play a constructive role to safeguard tariff concessions. Finding inspiration in this idea, Sykes

[3062] World Trade Report 2009, above n 3043, at xviii and 94-95; see also Sykes, above n 2661, at 104.
[3063] See Magnus, above n 3057, 991.
[3064] Even in that case, CVDs might not deter subsidization as they might divert subsidized products to other markets.
[3065] L. D. Qiu, 'Why Can't Countervailing Duties Deter Export Subsidization?', 39 *Journal of International Economics* (1995), 249-272. Recall that CVDs would hereby not necessarily target export subsidies that are detrimental for world welfare because output is sub-optimally low in strategic settings. Hence, one might argue that the lack of an effective deterrent effect should not be regretted given such CVDs fail to target 'wasteful' subsidies.
[3066] For instance, Sykes observes that countries lacking an import-competing industry would not only be legally prevented from taking such action (i.e., no injury to their domestic industry) but would obviously lack any incentive to impose such measures as well. Yet, this implies that CVDs will be used in an uncoordinated fashion, hereby limiting their deterrent effect.
[3067] World Trade Report 2009, above n 3043, at 95; Sykes, above n 2661, at 106.
[3068] See above Part IV, Chapter 2, Section 2.2.

acknowledges that, in theory, CVDs could serve a similar purpose because this unilateral response allows countries to effectively protect their domestic industry up to the bound level of tariff commitments. Hence, the CVDs option enables governments to effectively commit themselves vis-à-vis their import-competing industries that tariff cuts will not be further eroded by subsidized imports.[3069] In this way, CVDs would allow tariff concessions that would otherwise not have been made because of the risk of circumventing bound tariff levels by foreign subsidization. In a way, this systemic justification would provide a normative underpinning for the theory developed by proponents of the entitlement rationale: protecting the narrow interests of domestic producers by setting up a CVDs procedure could be considered justified insofar it reduces the political costs of governments to conclude trade agreements and thus allows them to make stronger tariff commitments. In short, the systemic justification acknowledges that trade concessions have a cost in political-economy terms and suggests that the CVDs instrument could help to reduce this cost. As Sykes has put it, this rationale is based on the simple premise that 'a little protection is better than a lot'.[3070] The 2009 World Trade Report equally considered that contingency measures (e.g., anti-dumping duties, CVDs, safeguards) could play a useful role in a trade agreement as they reduce the costs of signing such an agreement and thus allow countries to undertake deeper commitments.

But again, the effective role of CVDs in facilitating tariff concessions lacks empirical evidence. Sykes refutes a systemic justification of CVDs action precisely because of this lack of evidence documenting that the US CVDs law was pivotal to facilitate tariff concessions and that the overall level of protection would be greater in the absence of CVDs action. Sykes hereby highlights that:

> Nothing in the history of the U.S. countervailing duty laws suggests that they were enacted because of a concern that subsidies would be used to circumvent the lower tariffs that would prevail after a round of tariff concessions. To the contrary, the countervailing duty laws have existed since 1897, long before the formation of the GATT or the advent of major international tariff negotiations.[3071]

Upon closer examination, the first CVDs law ever imposed by the US (1890s) seems to fit rather well with the systemic justification, even though it dates from before the onset of reciprocal tariff negotiations.[3072] The US wished to cut tariff rates unilaterally (in order to reduce a Treasury surplus), but its sugar industry was at the same time confronted with subsidized imports. To protect their interests in face of such a general tariff cut, the US

[3069] See above Part IV, Chapter 2, Section 2.2.
[3070] Sykes, above n 2928, at 261.
[3071] Sykes, above n 2928, at 262-263.
[3072] The operation of these first CVDs laws is explained in Diamond, above n 2670, at 564-565.

Congress decided to offer CVDs in case foreign countries would subsidize exports of sugar. Hence, this CVDs law was apparently considered useful to reduce the political cost of a unilateral general tariff cut. In 1897, however, the US Congress increased tariffs to raise revenue and protect US industry. Because foreign countries could undo the effect of the tariff by offering export subsidies, the US also decided that additional CVDs would be charged to imports benefiting from export subsidies. Apparently, it was well understood that subsidized imports could erode tariff levels and that a specific tool, namely CVDs, could in theory effectively remedy this circumvention. This example illustrates that CVDs laws could be useful so as to implement lower general tariff levels, even outside the context of reciprocal tariff negotiations.

Obviously, such anecdotic evidence is insufficient to underpin the systemic justification for CVDs action. In the absence of such evidence, no definitive judgment can be made on the strength of this argument. Anyway, three propositions should hold to make the systemic justification valid. First, the beneficial effect on tariff concessions should certainly compensate for the 'little protectionism' generated by the (threat of) imposition of CVDs.[3073] Again, empirical studies are not conclusive on the exact trade-distortive impact of CVDs policies.[3074] Second, the import-competing industry should have confidence that CVDs are indeed an effective tool to preclude tariff erosion by foreign subsidization. What matters seems not so much whether CVDs are really effective to this end, but rather whether the trading community beliefs that it could play this role. Amply demonstrating that CVDs are not effective in leveling the playing field, Hudec seems to indicate that the illusion that CVDs could adequately respond to 'unfair trade' could have some merit on its own: 'by claiming the ability to police unfair trade, the law implicitly assured the business public that the rest of foreign trade was fair – something like the way a hanging assures the public that the streets are safe'.[3075] If the trading community recognizes that foreign policies having an equivalent effect are not effectively disciplined (e.g., undervalued exchange rates), the systemic value of

[3073] Here, it should be emphasized that even the threat of CVDs action could affect trade flows.

[3074] An overview of the literature on the economic impact of contingency measures can be found in World Trade Report 2009, above n 3043, at 152-156. Interestingly, Vandenbussche and Zanardi have found that anti-dumping measures not only negatively affect trade in the product on which the duty is imposed but that anti-dumping laws equally have a chilling effect on *aggregate* trade flows if they are used frequently. Comparing new frequent users' loss in imports due to such measures and their gains of further trade liberalization, Vandenbussche and Zanardi conclude that the chilling effect is 'too large to be dismissed as a "small price to pay" for further trade liberalization'. H. Vandenbussche and M. Zanardi, 'The Chilling Trade Effects of Antidumping Proliferation', 54 *European Economic Review* (2010), 760-777. One might hypothesize that a somewhat similar chilling effect on aggregate trade could occur as a result of CVDs action *if* such action would indeed be frequently undertaken by a country. Actually, any such effect would certainly seem to be lower as CVDs measures are far less often installed than anti-dumping measures. On the use of CVDs action, see above Part II, Chapter 6, Section 6.1.3.

[3075] Hudec, above n 2650, at 262.

CVDs seems to be reduced. Third, the systemic role of CVDs laws on tariff concessions obviously assumes that meaningful tariff cuts can still be made. Hence, this systemic justification gradually loses strength when deeper multilateral tariff cuts are made. This might question the validity of this justification for developed countries' CVDs action.

In case the systemic justification would be considered compelling, how would the disciplines on this unilateral action as set out in the SCM Agreement be evaluated? In line with the suggestion made by proponents of the entitlement theory, CVDs should only remedy injury caused upon import-competing industries. Indeed, it is only in that case that CVDs are needed to act as safety valve protecting tariff concessions. Therefore, making the lesser-duty-rule mandatory or rethinking the requirement to show a causal link between subsidized imports and injury might be on the agenda. On the other hand, proponents of the systemic justification would agree with those of the deterrent justification that an expansion of CVDs action by large (developing) countries would be welcomed: the former would point to the increase in deterrent effect, whereas the latter would indicate that such CVDs facilitate these countries to enter into deeper tariff concessions.

4.2.3. The absence of any justification

Scholars that are not persuaded by either the deterrence justification or the systemic justification cannot but reach the conclusion that the first-best reform would be to abandon the scope for CVDs action under the WTO.[3076] In the absence of a useful deterrent or systemic effect, the generally welfare-depressing impact of CVDs measures on both the CVDs imposing country as well as on the rest of the world suggests that governments would benefit if they mutually agree to exclude the option to undertake such unilateral action.[3077] It would be superior to 'tie their hands' in this way in order for countries not to be able to adopt CVDs in the narrow interest of their import-competing industry. Likewise, the same argument would hold if one considers that any useful deterrent or systemic effect of CVDs could be better obtained through the WTO dispute settlement system. If this multilateral track is followed, trade-distortive measures will not be imposed unless non-implementation of the DSB recommendations would lead to the imposition of countermeasures. Of course, this

[3076] See, for example, Sykes, above n 2928, at 263; Sykes, above n 2661, at 106; Trebilcock, above n 3053, at 732.

[3077] In those circumstances in which CVDs are welfare-improving for the CVDs-imposing country, its unilateral action comes at the expense of the rest of the world. Even if CVDs action could legally be restricted to those circumstances, such action can therefore not be endorsed from a normative viewpoint. Nonetheless, a reduced scope for CVDs might very well be considered more appropriate than the current system.

reasoning hinges on the assumption that the WTO dispute settlement system is deemed effective to this end.

Proponents of the abolition of the unilateral track are well aware that such fundamental reform is not realistic. In light of this ultimate objective, what types of reforms regarding disciplines on CVDs action could nonetheless be deemed legitimate?[3078] First of all, the procedural rights upon consumers in CVDs procedures could be strengthened. For instance, one could propose the obligation that consumer organizations and downstream industries are included in the list of 'interested parties' in CVDs investigations.[3079] By upgrading the influence of those actors negatively affected by such measures, CVDs action serving the narrow interest of the import-competing industry would in the end be reduced. Still, because such reform would reduce the deterrent and systemic effect of CVDs action, it would likely not find support among proponents of those theories. Next, making the lesser-duty-rule mandatory as suggested under the systemic justification might also be considered appropriate because it would reduce the level of CVDs in case the subsidy level exceeds the injury to the domestic industry. Finally, expansion of CVDs action by non-traditional users (e.g., large developing countries) would not be advisable because of the welfare-detrimental effect of such unilateral measures, unless this would make the traditional users like the US more open to strengthen existing disciplines. Note in concluding that the international fragmentation of production might also make reforms limiting the scope for CVDs action more acceptable to WTO Members because of the welfare and political-economy costs of such measures on downstream industries. For the same reason, further fragmentation would likewise make such reforms less needed because CVDs action will be less swiftly undertaken as a result.

[3078] According to Sykes, the directions for such reform are not apparent. See Sykes, above n 2928, at 263.
[3079] See Articles 12.9 and 12.10 of the SCM Agreement. See above Part II, Chapter 5, Section 5.2.3.1.

5. DISCIPLINES ON SUBSIDIES IN LIGHT OF POLICY RESPONSES TO THE ECONOMIC CRISIS

In this final section, we address governments' responses to the recent financial and economic crisis insofar these measures touch upon subsidy disciplines under the SCM Agreement.[3080] Some observers have questioned whether the SCM Agreement leaves sufficient policy space upon governments to adequately respond to the challenges of the current crisis. Others, on the other hand, have precisely pointed to the weaknesses in the current system to prevent 'beggar-thy-neighbour' subsidies and have thus advocated more multilateral policy constraints.

At first sight, any appeal to increase flexibility on subsidy disciplines during times of global economic downturn seems to be somewhat counterintuitive. As shown by the experiences in the 1970s and 1980s, such a downturn puts pressure upon governments to enter into competitive subsidization so as to safeguard domestic production and employment. Hence, it would rather offer an incentive to strengthen subsidy disciplines in order to stop detrimental subsidy wars generating over-capacity and budgetary difficulties. Given that the Subsidies Code was largely unsuccessful to halt such 'beggar-thy-neighbour' policies, countries were ready to agree upon more stringent subsidy disciplines during the Uruguay Round.[3081] Yet, a particular feature of the current crisis is that it precisely mandated increased government interventions to prevent a collapse of the financial system as well as to boost aggregate demand through stimulus packages (i.e., so-called Keynesian interventions). Some observers hold that the strengthened disciplines on subsidies under the SCM Agreement would in legal terms – or at least in spirit – be at odds with such an increased role of the government in the economy. By scrutinizing government interventions in light of the SCM Agreement, this discussion will show that this concern has to be tempered.

First, several governments bailed out large financial institutions in distress as immediate response to the crisis, which was justified on the basis of the systemic risk that their potential

[3080] For an overview of measures adopted by WTO Members, see *Report to the TPRB from the Director-General on the Financial and Economic Crisis and Trade-related Developments* (JOB(09)/30, 26 March 2009). An in-depth legal analysis of some of these interventions can be found in C. Brunel and G. C. Hufbauer, 'Money for the Auto Industry: Consistent with WTO Rules?', *Policy Brief – Peterson Institute for International Economics* (February 2009), 12 pp.; A. van Aaken and J. Kurtz, 'Prudence or Discrimination? Emergency Measures, the Global Financial Crisis and International Economic Law', 12:4 *Journal of International Economic Law* (2009), 859-894; R. H. Weber and M. Grosz, 'Governments' Interventions into the Real Economy under WTO Law Revisited: New Tendencies of Governmental Support of the Automobile Industry', 43 *Journal of World Trade* (2009), 969-1012.

[3081] The Great Depression of the 1930s similarly inspired countries to negotiate disciplines on export subsidies after the Second World War, but such disciplines were finally not adopted because of the failure to ratify the Havana Charter (see above Part II, Chapter 1, Section 1.1).

bankruptcy would pose to the financial and real economy. Insofar governments did not direct financial institutions to channel this support to (specific) domestic producers, this aspect of the recovery programme targeting the financial service sector is not disciplined under the SCM Agreement.[3082,3083] Arguably, in case an explicit 'lend national requirement' would be attached to such support, the government would offer a subsidy in the meaning of the SCM Agreement given that it directs a private actor (i.e., the financial sector) to make a financial contribution (e.g., transfer of funds) that would otherwise not have been available to domestic producers.[3084] In this case, however, such subsidies will only be actionable if it can be demonstrated that they are specific to certain enterprises within the subsidizing country and cause adverse effects upon other WTO Members.[3085]

Second, with regard to Keynesian interventions implemented to boost aggregate demand, three different forms have been distinguished: measures increasing direct public spending, fiscal stimulus aimed at consumers, and fiscal stimulus aimed at producers.

The first two forms of stimulus measures directly target public and private consumption respectively. Both types do not trigger substantive disciplines under the SCM Agreement if they are implemented in non-discriminatory way. After all, such measures do not qualify as a specific subsidy to enterprises within the jurisdiction of the granting authority and do not cause adverse effects upon foreign producers.[3086,3087] Because they do not inherently

[3082] Any distortion created in the service sector itself should be scrutinized under the GATS. Generally speaking, the GATS does not substantively curtail such bailout measures because of the lack of strong subsidy obligations in the absence of specific commitments and the presence of important exceptions such as the prudential carve-out. For an analysis of these financial sector bailouts under the GATS, see B. De Meester, 'The Global Financial Crisis and Government Support for Banks: What Role for the GATS?', 13:1 *Journal of International Economic Law* (2010), 27-63; van Aaken and Kurtz, above n 3080, at 871-876.

[3083] The Appellate Body has emphasized that 'entrustment or direction' (Article 1.1(a)(1)(iv) of the SCM Agreement) would not be present in 'the situation in which the government intervenes in the market in some way, which may or may not have a particular result simply based on the given factual circumstances and the exercise of free choice by the actors in that market'. Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 114.

[3084] According to the Appellate Body, 'direction' covers situations where the government exercises its authority over a private body (Appellate Body Report, *US – Countervailing Duty Investigation on DRAMS*, para 116). Relevantly, the Appellate Body also held that there could be 'direction' by the government even when the financial contribution is made on commercially reasonable terms (Appellate Body Report, *Japan – DRAMs (Korea)*, para 138). Demonstration of such 'direction' of a private actor within the meaning of Article 1.1(a)(1)(iv) of the SCM Agreement would be much more difficult in the more likely case that such direction is implicit. On the standard for demonstrating 'direction', see above Part II, Capter 3, Section 3.2.1.2.

[3085] Likewise, specific subsidies would be countervailable if causing injury to the domestic industry.

[3086] See also Brunel and Hufbauer, above n 3080, at 9. Examples of fiscal stimulus measures targeting consumers are tax credits for the purchase of cars or so-called 'Cash for Clunkers' programmes. Under a 'Cash for Clunker' programme (as for instance, implemented in the US and Germany), a compensation is offered to owners of old cars if they purchase more energy-efficient cars. If such consumer subsidies would discriminate against foreign producers, a tentative argument could be made that these subsidies are challengeable under the SCM Agreement disciplines on actionable subsidies in case such subsidies could be demonstrated to have passed-through to domestic producers. Yet, a discriminate between foreign and domestic producers, such consumption stimulating measures are not only WTO-compatible but they are also the most efficient way to boost global demand.

In contrast, fiscal stimulus measures aimed at producers are more likely to fall within the ambit of the SCM Agreement disciplines. Here, functional as well as selective interventions aimed at domestic producers could be discerned.

Firstly, according to an IMF study discussed in Part I,[3088] non-sector specific credit guarantees by governments for producers in financial distress could be legitimate when confronted with a capital market failure. Such government guarantees in times of a credit crunch would qualify as subsidies under the SCM Agreement because these constitute potential direct transfers of funds that confer a benefit to the recipient.[3089] If allocation is strictly based on objective criteria, however, such guarantees might be classified as non-specific under Article 2.1(b) of the SCM Agreement, unless it could be demonstrated that they are predominantly used by certain enterprises (*de facto* specificity). Only in the case where such guarantees could be classified as specific to certain enterprises, an actionable subsidy claim or a CVDs action could be considered.

Secondly, large selective interventions in which specific sectors are bailed out are more problematic in both efficiency and legal terms. The prototypical example is the large support given to the car sector in a number of WTO Members, such as the US and certain EC countries. These interventions took the form of loans, loan guarantees, or equity infusions. Such (potential) direct transfers of funds to a specific recipient at better-than-market terms fall within the reach of the SCM Agreement.[3090] Again, such specific domestic subsidies are not prohibited *as such* but are only vulnerable to an actionable subsidy claim or unilateral CVDs action. These interventions' large scale suggests that bailouts might very well cause adverse trade effects upon foreign producers.

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straightforward claim that these discriminatory measures violate Article III of the GATT would be more likely in first order.

[3087] The relevant agreement with regard to direct public spending is the plurilateral Agreement on Government Procurement. This agreement also incorporates a national treatment obligation but this is only useful for those WTO Members that have signed this agreement. For an analysis of 'buy national' conditions attached to public spending under this plurilateral agreement, see van Aaken and Kurtz, above n 3080, at 871-881. The suggestion put forward by some scholars that 'buy national' provisions in procurement programmes could be challenged as actionable subsidies under the SCM Agreement seems highly speculative in light of the subsidy definition under the SCM Agreement and the plurilateral nature of the Agreement on Government Procurement (*juncto* Article III:8(a) of the GATT).

[3088] See above Part I, Chapter 2, Section 2.5.

[3089] If the private capital market no longer offers credit at affordable terms, such government guarantees render credit transactions possible that would otherwise not have taken place. The potential fee charged for such government guarantees will not compensate for this benefit. Articles 1.1(a)(1)(i), 1.1(b), and 14(c) of the SCM Agreement.

[3090] Brunel and Hufbauer also conclude that 'government loans and guarantees to auto companies around the world invariably entail below-market interest or credit-guarantee rates'. Brunel and Hufbauer, above n 3080, at 7.

In evaluating the success chances of the multilateral track, it is important to underline that demonstration of a *threat* of serious prejudice to other countries' trading interests is sufficient to find a violation of Article 5 of the SCM Agreement and to trigger the remedies available in Article 7 of the SCM Agreement. As Hufbauer and Brunel have emphasized, gathering sufficient data to show *actual* serious prejudice might be much more difficult in an early case against such bailouts. In legal terms, it is not relevant that the complaining WTO Member would have similarly subsidized its own car industry.[3091] Of course, in political terms, such competitive subsidization might decrease the probability that such multilateral claim is formulated.[3092] Moreover, the time-consuming dispute settlement procedure and the fact that any remedy would not work retroactively might further reduce the appeal of this multilateral track. Hufbauer and Brunel state that it is somewhat more probable that WTO Members would opt for the unilateral track to offset the (threat of) injury to their domestic industry.[3093] Hereby, WTO Members have to adhere to the specific procedural and substantive disciplines set out in the SCM Agreement before any provisional or definitive CVD could be imposed. Even if CVDs are put in place, it is implausible that such unilateral measure would effectively constrain bailouts in the car industry.[3094]

Overall, the SCM Agreement thus seems to leave considerable policy space to implement Keynesian types of interventions. One might even argue that existing disciplines insufficiently rule out that fiscal stimulus packages are implemented in a trade-distorting way. Reintroducing the catch-phrase developed in Part I, one could therefore conclude that the SCM Agreement seems to allow 'Keynes at home' but does not seem to ensure 'Smith abroad'.[3095] After all, the most inefficient and trade-distorting stimulus measures, namely those in which specific domestic sectors are bailed out by large government injections, are not straightly prohibited but only actionable and countervailable. Somewhat ironically, the US proposed in the Doha Round negotiations to exactly prohibit those types of subsidies.[3096] If such a prohibition had already been put in place at the onset of the economic downturn, this would have outlawed the bailouts in the car sector and might have pushed WTO Members towards the more efficient types of Keynesian interventions in order to boost global demand (i.e., those targeted at consumption). On the other hand, a rigorous prohibition might have made WTO Members reluctant to implement any fiscal stimulus plan whatsoever (i.e., wait

3091 Brunel and Hufbauer, above n 3080, at 7-8.
3092 Yet, the mutual claims by the US and the EC against each others aircraft subsidies indicate that this is not inconceivable as well.
3093 Brunel and Hufbauer, above n 3080, at 8-9.
3094 See also Hufbauer and Brunel, above n 3080, at 10.
3095 See above Part I, Chapter 2, Section 2.5.
3096 *Proposal from the United States, Expanding the Prohibited "red light" Subsidy Category, Draft Text* (TN/RL/GEN/146, 5 June 2007).

until 'Keynes comes from abroad') or might have inflicted more systemic protectionist tendencies. Arguably, a careful way to partly limit the risk of competitive subsidization in the future could be the re-establishment of the presumption formulated under Article 6.1 of the SCM Agreement. Here, the presence of serious prejudice would be presumed in case developed countries offer subsidies that cover operating losses sustained by an industry or enterprise, except for one-time non-recurring subsidies enabling an enterprise to develop a long-term solution and avoid acute social problems. Yet, it seems doubtful that WTO Members will agree upon even the mere reactivation of this presumption under Article 6.1 of the SCM Agreement.

GENERAL CONCLUSION

At one time, one could claim in US Congress that 'the definition of a subsidy, like that of beauty, varies with the beholder whose eye is focused on the object under scrutiny'.[3097] Looking at the full spectrum of government actions, an 'open-minded' beholder could detect subsidies everywhere. An effective police service or educational system could be regarded as a subsidy because they clearly benefit the domestic industry. A creative observer could even label negative action by the government as a 'regulatory subsidy' when this government refrains from providing a certain level of regulation. Overall, the range of subsidies will vary depending on the views of the beholder on the proper role of the government and the market. However, since 1995, the SCM Agreement has narrowed the field of vision. Indeed, only specific subsidies within the meaning of the definition stipulated in the SCM Agreement are disciplined under this agreement and could thus be challenged before the WTO dispute settlement system. Equally important, only those specific subsidies could be subject to unilateral CVDs action by other WTO Members.

Beholders have articulated two important lines of criticism on the SCM Agreement's demarcation of a subsidy. First, some observers have advanced that the field of vision might have been overly constrained. Yet, this study has shown how the subsidy-concept seems sufficiently broadly formulated and explained in the case law so as to capture the most common forms of subsidization. It is sensible that some general government interventions, like low levels of environmental protection or an undervalued exchange rate, fall outside its scope. The WTO's dispute settlement system – and its institutional setting more generally – is not equipped to define the appropriate level of such interventions. This certainly holds for individual CVDs-investigating authorities. Allowing unilateral CVDs action against such general interventions would risk opening Pandora's box. Second, other beholders seem to have suggested that the subsidy-concept is too broadly defined. In a sense, it has been revealed how the subsidy demarcation in fact fails to distinguish 'beautiful' from 'ugly' subsidies. Indeed, by installing the private market test, the subsidy definition does not shield corrective subsidization from subsidy disciplines and potential CVDs action. Except for excluding some general public goods, the specificity test seems also not very useful in drawing this distinction. Corrective subsidies targeted to certain industries certainly pass this threshold and subsidies based on general objective criteria could also be *de facto* specific. Here, this dissertation's analysis has suggested that the objective of the subsidy could be better taken into account under the respective disciplines rather than under the specific subsidy definition in the first place. Otherwise, it would again rest upon the shoulders of the WTO dispute settlement system (and CVDs-investigating authority) to second-guess and give appropriate weight to Members' objectives in offering subsidies.

[3097] US Congress, House Committee on Agriculture (1972), cited by G. Schwartz and B. Clements, 'Government Subsidies', 13:2 *Journal of Economic Surveys* (1999), 119-148, at 120.

The suggestion to consider the policy objective relevant under the respective disciplines leads us to the evaluation whether the substantive disciplines leave sufficient leeway for WTO Members to rely upon subsidization as legitimate policy tool. On this question regarding the balance between policy space and policy constraints, this dissertation has reached the following findings with regard to developed and developing countries, respectively.

Starting with the subsidy disciplines on developed countries, this study has documented the problematic aspect that the existing disciplines on domestic subsidies merely focalize on their potential trade effects upon other WTO Members and simply disregard whether these subsidies are granted to pursue a legitimate policy objective. In this respect, the original SCM Agreement struck a more appropriate balance since it excluded some legitimate subsidies from multilateral disciplines and unilateral CVDs action. Therefore, the reactivation of the green light status of well-defined R&D, environmental, and regional subsidies should be endorsed. At the same time, the original SCM Agreement did also put more constraints on some forms of subsidization as it provided a rebuttable presumption that certain subsidies caused serious prejudice upon other WTO Members. Arguably, such a presumption with regard to subsidies to loss-making firms could somewhat temper the risk of a detrimental subsidy competition among developed countries in times of a global economic downturn. While endorsing the policy flexibility under the original SCM Agreement for certain green light subsidies, this dissertation's analysis does certainly not support other authors' plea to return to the pre-SCM Agreement era. The systemic concern that existing disciplines would undermine tariff concessions should not be overstated since developed countries' tariff levels on industrial products are already largely cut. At most, this systemic argument might justify the reinstallation of a limited peace clause under the Agreement on Agriculture so as to facilitate tariff negotiations on agricultural products.

Turning to the prohibition on export subsidies, some scholars have criticized that this would run counter to efficiency because it would lead to trade levels lower than those set by individual countries. Hence, any economic argument underpinning a multilateral restriction on export subsidies must overcome this basic dilemma. However, I disagree with the argument's central premise. Its normative inference does not seem to acknowledge that such export subsidy competition is detrimental not only for the subsidizing country but also for world welfare as a whole. The fact that *world* welfare would generally improve if export subsidies are ruled out *justifies* that such a ban is inscribed, whereas the fact that welfare in a previously *subsidizing country* would improve helps *explaining* why such a ban is inscribed. The normative welfare conclusion also justifies trimming down the existing policy space to offer agricultural export subsidies. On the other hand, a specific and limited exception on the basic prohibition on export subsidies might seem justified if the market failure precisely affects the trade transaction. The capital market failure in trade financing of medium- and long-term transactions to developing countries and of short-term transactions in times of a financial crisis might warrant government intervention so as to support such trade flows. The safe haven installed under the Illustrative List and referring to the OECD Arrangement precisely crafts an exception for governments to offer export credit support at subsidized terms. Yet, this dissertation has revealed that the scope of this safe haven currently offers no justification for the most common type of such support (e.g., pure cover support) and for short-term support. Consequently, the WTO Director-General is urging to offer export subsidies simply prohibited under existing WTO rules. While this might suggest that policy space is overly constrained in this respect, the most effective way to offer support for trade financing is not legally constrained. Indeed, export credit support offered by regional or multilateral financial institutions would be superior in both economic and legal terms.

Regarding the legal framework applicable to developing countries, the SCM Agreement explicitly recognizes the importance of subsidies for spurring development. At the same time, the SCM Agreement constrains these countries' freedom to rely upon this policy instrument and does not foreclose that other WTO Members undertake unilateral CVDs action. A group of low-income developing countries is still exempted from the ban on export subsidies, whereas some small-trading countries also benefit from a limited exemption until 2015. Economic theory and empirical evidence clearly justify this S&D treatment but likewise suggests that the exposure of their export subsidies to actionable subsidy claims and CVDs action is too unrestrained. Graduation in case of export competiveness could, on the other hand, be useful as an exit-mechanism when explicit export promotion is no longer strictly needed.

All other developing countries are currently subject to the prohibition on export subsidies. Hence, the Illustrative List of Export Subsidies, resulting in essence from the bargain between developed countries over the years, has become fully applicable to these developing countries. Important in this respect, the discussion on export credit support has demonstrated that the case law has as much as possible prevented that this Illustrative List works against the interest of developing countries. To this end, an *a contrario* reading of the cost-to-government benchmark formulated for export credit support has been rejected and the leeway to OECD Participants to modify the scope of the safe haven has been confined. The fact that the safe haven still remains in the – somewhat tied – hands of the OECD Participants is a legitimate concern expressed by developing countries that has to be dealt with in future negotiations.

Obviously, the general ban on export subsidies firmly restrains these developing countries' policy options. Nonetheless, the fundamental concern voiced by some observers that the SCM Agreement precludes developing countries to duplicate the successful development strategy of East Asian Miracle countries has to be nuanced as well. The prohibition on export subsidies imposed upon other countries at equal or higher development levels implies that similar leeway is not necessarily needed to penetrate export markets. Furthermore, economic research has shown that policy space on domestic rather than export subsidies becomes pivotal for countries that have reached higher stages on the development ladder. Often left unnoticed, the SCM Agreement does offer more policy flexibility in this regard, though it has been explained that the exact scope thereof is not fully clear. Arguably, only multilateral claims based on nullification of tariff concessions or injury to the domestic industry could be formulated against developing countries' domestic subsidies. From a normative perspective, this narrow interpretation would be justified not only on the basis of the importance of corrective subsidies but also because it would facilitate further tariff concessions by developing countries (i.e., systemic argument). Finally, procedural and substantive disciplines upon unilateral CVDs responses by other countries have been elaborated under the SCM Agreement. In legal terms, the higher *de minimis* threshold makes it more difficult to impose CVDs against imports from developing countries. In reality, however, this somewhat higher burden does not preclude that the large majority of CVDs action is taken *by* developed countries *against* imports from developing countries. Neither the deterrence justification, nor the systemic justification could validate this asymmetric practice. Hence, further raising the *de minimis* threshold to initiate such CVDs action against developing countries' imports seems defensible.

To summarize, this dissertation has pointed to some specific elements to rebalance existing disciplines on subsidization and CVDs measures in the forestalled Doha Round. At the same time, a fundamental overhaul of the subsidy disciplines regarding developed and developing countries seems neither realistic nor warranted. To be sure, this dissertation has likewise revealed that the beauty-metaphor still holds. Just as beauty does, the need for policy space and constraints on subsidization will always provoke fundamental divergence among beholders.

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